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Europe's Third Energy Package: Unbundling

16 November 2011

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The European Commission's ongoing efforts to open up the European Union's energy market should mean good news for investors into the sector. The Commission's liberalisation agenda, allied to very significant demand for investment in new gas and electricity infrastructure, should ensure favourable conditions for financial investors, including funds and private equity houses. Against this background, the passage in 2009 of the Commission's latest round of market opening legislation (known colloquially as the "Third Energy Package") should have been another helpful step. In practice, however, things are not that straightforward - complicated in part by the way in which the legislation has been drafted.

As stakeholders wake up to the implications, the effect looks to be potentially to impose significant constraints on some investors' plans to take interests in different energy asset classes within the EU and even to force further divestments. To complicate matters further, member states are taking different approaches to how to transpose the Third Energy Package into national legislation.

The root of the problem: the "unbundling" agenda

A central theme of the Third Energy Package is the separation of ownership - or at least control – of the natural monopoly assets of electricity and gas transmission networks on the one hand from ownership (or control) of generation, production and supply assets – which are, in theory at least, open to competition - on the other. This is known as "unbundling". The theory goes that network owners who also own generation, production or supply might be tempted to operate their networks or craft their network investment plans in such a way as to favour their own generation, production or supply businesses - to the detriment of the rest of the market, especially potential new entrants.

The cornerstone of the unbundling provisions – and the Commission's starting point - was that there should be no cross-control between the two classes of asset at all; in other words, "full unbundling". This drastic approach was unacceptable to some member states, which lobbied for limited exemptions to protect their domestic utilities which remained "vertically integrated", in that they continued to own generation, production and supply alongside transmission and transportation. The final Third Energy Package therefore includes provisions which allow continued ownership of both types of asset, subject to stringent requirements for independent operation of networks. These exemptions from full unbundling are, however, only available to network owners which were part of "vertically integrated utilities" as of September 2009, when the Third Energy Package was passed. They are therefore unlikely to be available to most financial investors.

The concept of “control”

The unbundling provisions of the Third Energy Package are triggered where the interests held in the two types of asset both confer “control”. The concept of control adopts the definition used in EU merger legislation and it is a wide one. Passive financial interests, having only the right to receive dividends, will not have control but that aside, the concept extends beyond simple majority share ownership to include interests which confer “decisive influence”. Decisive influence can consist in ownership of assets (or the right to use them) or in powers over the make-up or decision-making of the board of directors or equivalent managing body. “Control” means both in law and in fact and includes indirect control (for example, via a subsidiary). Importantly, it also covers the concept of “negative control” whereby a minority shareholder has the right to veto major strategic decisions of a company such as the budget, business plan, major investments or the appointment of senior management. For example, an interest in a 50/50 joint venture, involving no overall majority equity stake, will still confer “control” if it confers the right to block resolutions at board and shareholder level on important strategic matters. This is likely to be an important consideration for all investors who wish to hold their equity other than through a simple investment fund.

Cross-sector application and jurisdictional reach

The Third Energy Package operates across both the electricity and gas sectors so that holding controlling interests in both a gas network asset and electricity generation will be caught by the unbundling requirements as, conversely, will be controlling interests in an electricity transmission link alongside an upstream gas production asset.

Jurisdictionally, the unbundling provisions are phrased in pan-EU terms; in other words, they restrict co-ownership of assets without geographic limitation. Having “control” of generation, production and supply assets alongside “control” of transmission or transportation networks is therefore precluded across the EU. The Package contains no carve-out for circumstances where there is no physical link between the particular generation, production or supply asset and the network(s) in question and where there is therefore no real danger of anti-competitive behaviour. If an investor holds a controlling interest in wind generation in Italy and is looking to acquire a controlling interest in a gas pipeline in Spain, it is perhaps difficult to see how the investor’s operation of the particular transmission asset could be influenced by its ownership of wind assets in another country, yet the unbundling provisions still preclude this. The theory is that the EU energy market is one single market, rather than 27 separate, albeit interlinked, markets, but the strict application of this theory to these situations would not necessarily lead to the promotion of a single EU energy market and could in fact deter investment in important projects.

A carve-out – at least in the UK

The approach which the Department of Energy and Climate Change ("DECC") is taking to implementation of the Package in the UK at least provides some welcome relief in that it restricts the scope of generation, production and supply to undertakings which require (or which, if in the UK, would require) a licence to carry out their business. Hence, for example, the implementing legislation excludes from consideration generating stations which do not require a generating licence by virtue of having a capacity of less than 100MW and an output of no more than 50MW. Ofgem does retain a discretion to take such excluded assets into account where there is in practice a real risk of anti-competitive behaviour – e.g. because the power station is physically linked to the network in question. Subject to that, the carve-out will at least allow investors to hold a controlling interest in, for example, a small onshore wind farm alongside a controlling interest in, say, an offshore transmission link.

Many other EU member states do not appear to be adopting a similar approach, however. Crucially, it is the energy regulatory body in the member state in which the transmission asset is situated which will be responsible for administering the Package. Whilst owning a small onshore wind farm in the UK will not preclude an investor from owning an offshore transmission link in the UK, it may well preclude it from owning a transmission asset in another European jurisdiction if the regulator there does not apply a similar test to that in the UK.

When will all this come into force?

The Third Energy Package was supposed to have been incorporated by EU member states into domestic law by March this year, with the application of the "unbundling" provisions being deferred for a year. No member state achieved the deadline of March 2011 but officially at least, the deadline for implementation of the unbundling provisions remains 3 March 2012. From that date, all transmission networks within the EU must have become certified by the national regulator where the network is located as compliant with the requirements of unbundling. Member states have a choice as to whether to make the exemptions to full unbundling available.

Earlier this summer, DECC published draft implementing legislation for the UK which came into force on 10 November. Ofgem, the energy regulator, is the certifying authority for the UK. Given the minimum timetable for certification set out in the Third Energy Package, the reality is likely to be that the March deadline slips by a few months.

The impact on investors

The width of the unbundling provisions seems bound to impose significant restrictions on investment in energy assets within the EU. Subject to exclusions such as those applying in the UK, any investor with a controlling interest in a transmission or transportation network will be precluded from acquiring a controlling interest in a generation, production or supply asset anywhere within the EU, and vice versa.

There are obviously significant investment opportunities in most EU countries, both in generation, production and supply and in networks. Acquisition of these classes of assets will therefore require careful analysis of the regulatory regimes of the other EU countries in which the investor may wish to invest in the future if the investor wishes to avoid the risk of forced divestiture or of having to restructure its interest.

The situation is especially surprising against the background of an EU energy sector which requires several hundred billion euros of capital investment over next decade or two as it strives to meet stringent climate change and energy security targets and to cope with a significantly different electricity generation portfolio.

Is there a solution to the problem?

Depending upon investment requirements, it may be possible to structure around the problem by ensuring that ownership interests in one type of asset or the other do not qualify as “controlling”. For example, adopting long term arrangements usually found in an investment fund management structure, whereby an independent third party is tasked with management of the asset and can exercise rights akin to those of a shareholder may have the effect of divesting “control” in certain circumstances. Such structures would require careful consideration on a case by case basis.

We are aware that some investors are taking the view that, where there is no real danger of an anti-competitive outcome, they should proceed anyway and hope that either the unbundling provisions are eventually amended to allow greater flexibility for financial investors or that they are not enforced too literally. However, although some governments are now lobbying the Commission for change, there is as yet no sign that this will materialise and if it does not, then this approach runs the risk of a forced divestiture or restructuring.

Our involvement

Through our extensive network of offices within the European Union, we have advised a number of clients on this issue. We are also continuing an active dialogue with DECC and Ofgem on the development and application of the Third Energy Package in the UK.

Linklaters has been involved in most of the high-profile activity in the energy sector globally in recent years, having acted on many of the largest, most complex, multi-jurisdictional and cutting edge transactions around the world to date. The firm's energy lawyers offer peerless knowledge and experience across the sector including power generation (thermal, nuclear and renewable), oil and gas (exploration and production, transportation, petrochemicals and refineries, LNG), networks (electricity transmission and distribution) and energy trading and commodities.

Consistently ranked as a top tier law firm in energy, the energy group includes specialists from Linklaters' pre-eminent corporate/M&A, banking and finance, projects, competition/antitrust, regulatory, environment and planning, tax and structured finance groups. With more than 50 partners and over 180 other lawyers dedicated to energy work across our network, Linklaters can provide full global coverage to meet clients' needs.

Our European Competition/Antitrust practice is well established and highly respected in the market. With approximately 30 competition specialists practicing in each of the Brussels and London offices, we have the strength and depth to take on a broad range of matters for market-leading clients. Strong practices in Düsseldorf, Paris, Madrid, Lisbon, Milan, Amsterdam, Stockholm, Moscow and Warsaw are an integral part of the global team and it is through this network that we are able to efficiently co-ordinate multi-jurisdictional cases and antitrust issues while maintaining an excellent understanding of and ability to implement local antitrust law.

Key contacts

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