

BRIEFING

INVESTING IN UK CRITICAL ENERGY
INFRASTRUCTURE – A COMPLIANCE
PATHWAY

NOVEMBER 2017

- EMERGING POSITION ON CRITICAL ENERGY INFRASTRUCTURE
- UK ACTION TO DATE
- SOME MODELS FOR A WIDER FOREIGN INVESTMENT CONTROL REGIME
- CONCLUDING THOUGHTS



“A MAJOR THEME IN COMMON WITH MANY OTHER G7 ECONOMIES IS THE RENEWAL OF CRITICAL INFRASTRUCTURE.”

The UK government is still very much in the process of establishing its policy regarding the key economic challenges facing the country in the coming decades. As was clear from the issue of green papers on its industrial strategy on 23 January 2017¹, and on proposed reforms to the merger system on 17 October 2017², a major theme in common with many other G7 economies is the renewal of critical infrastructure.

Foreign direct investment is a legislative competence which passed from the UK parliament to the EU Commission, as part of the Treaty on the Functioning of the European Union in 2010. Energy is a shared competence and so the area of critical energy infrastructure is an area in which the UK can formulate national policy. Following the UK's recent vote on Brexit, the UK may seek to pull together existing legislation and policy into a clearer general statute on foreign investment. This new regime would sit alongside any other trade agreements, whether with the EU or other countries.

It is useful to look both at the recent history of UK foreign investment control and referable indicators from the legal systems of similar jurisdictions, particularly in the Commonwealth.

¹https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/585273/building-our-industrial-strategy-green-paper.pdf

² <https://www.gov.uk/government/news/government-updates-mergers-regime-to-protect-national-security>

“THE UK IMPOSES FEW CONTROLS ON FOREIGN INVESTMENT. FOREIGN INVESTORS MUST PRINCIPALLY COMPLY WITH MONOPOLY AND MERGER RULES AND RESTRICTIONS AROUND ANY PRE-EXISTING GOVERNMENT INTEREST.”

Emerging position on critical energy infrastructure

The UK imposes few controls on foreign investment. Foreign investors must principally comply with merger control rules and restrictions around any pre-existing government interest, such as a golden share obtained on privatisation. Even in the defence sector, there is no formal rule restricting foreign participation³.

One exception, in common with other countries, is national security. However, unlike in other legal systems, there is no clear link between this criteria and a definition of critical infrastructure. This is largely because UK legislators have not yet sought to define what critical infrastructure assets are.

Definitions in other EU jurisdictions are open-ended: Germany’s critical infrastructure policy refers to infrastructure whose disruption would cause “significant disruptions to public order or other dramatic consequences”; and the Netherlands’ to infrastructure whose disruption would result in “major social disturbance”, “tremendous loss of life” and “economic damage”.

In many Commonwealth legal systems, the definitions are more direct. In Canada, the definition is “critical infrastructure consists of those physical and information technology facilities, networks, services and assets which, if disrupted or destroyed, would have a serious impact on the health, safety, security or economic well-being of Canadians or the effective functioning of governments in Canada”. Australia’s parliament is currently considering a Security of Critical Infrastructure Bill 2017 and associated rules which define critical infrastructure assets as specific electricity, water and port assets, whilst also allowing further assets to be added to these categories by effect of the rules or by a declaration of the responsible minister.

In the US, by way of Proclamation 9665 of 31 October 2017, President Donald Trump declared November 2017 to be the US national Critical Infrastructure Security and Resilience Month⁴.

What, more specifically, has the UK done?

UK action to date

The formal framework is still a work in progress. The *Enterprise Act 2002* grants the Secretary of State special powers to serve an intervention notice where a proposed merger represents a threat to national security, media plurality or the stability of the UK financial system. Intervention notices have been served to date on all of these grounds. The proposed reforms to UK merger control announced on 17 October 2017 do not seek to replace this “call-in” power but supplement it. The significance of this proposal lies in its express link between national security and investment in specific parts of the UK economy: civil nuclear, defence and “key new projects” or “specific businesses or assets”.

³ There is an informal process for clearance from the Ministry of Defence for any investment or divestment where there is a contract in place with the MoD, although these rules are not in the public domain

⁴ <https://www.federalregister.gov/documents/2017/11/06/2017-24278/critical-infrastructure-security-and-resilience-month-2017>

More direction can be discerned from recent administrative decisions.

In the offshore oil and gas industry, national security has arisen in a number of cases. Production at the Rhum field, a major gas field in the North Sea in which BP and the National Iranian Oil Company (“NIOC”) each have 50% shares, was halted in 2010 due to the international sanctions regime imposed upon Iran. Off-takers were prevented by sanctions from paying NIOC for off-take and any new investment would have breached sanctions. In 2013, citing field safety reasons around the difficulties of decommissioning high pressure gas fields, the Secretary allowed BP to recommence production if NIOC’s interest was managed by the (then) Department of Energy and Climate Change⁵. NIOC’s interest in the field, was effectively expropriated on the stated grounds of safety pending the lifting of sanctions.

A further case arose when the Secretary of State blocked the sale of 12 North Sea gas fields to LetterOne, as its Russian owners might become subject to EU sanctions in the future. Although the parties to the transaction devised a complex structure involving a specially formed Dutch foundation able to step in and temporarily operate the fields should that happen, the Secretary of State stated that he would be compelled to order the sale of the fields to a third party, again on health and safety grounds, if the deal were to proceed⁶. Such interventions have been few but there is concern as to what a widening of criteria would mean to the UK’s ability to attract critical infrastructure investment.

“THE DECISION TO ALLOW FRENCH AND CHINESE INVESTMENT IN THE HINKLEY POINT C NUCLEAR POWER STATION ON 15 SEPTEMBER 2016 IS SIGNIFICANT.”

In this context, the decision to allow French and Chinese investment in the Hinkley Point C nuclear power station on 15 September 2016 is significant. The decision was made with a nod to the existing national security criteria but went further. In letters exchanged by the major French investor, EdF, and the Secretary of State, further conditions were imposed that point to policy reform of the *Enterprise Act 2002*. Principally, foreign investors will not be able to sell significant stakes in new nuclear projects prior to the completion of construction without government consent. The government also stated that it would take a “special share” in all future nuclear newbuild projects, or will impose conditions to prevent stakes being sold without its consent. This effectively extends the *Enterprise Act 2002* powers of intervention to critical infrastructure projects still in the construction phase. Significantly, the Hinkley Point decision stated that there will be reforms to ensure that foreign ownership of critical infrastructure is scrutinised for security under the public interest regime in the *Enterprise Act 2002*⁷.

The UK government’s announcement of a new industrial policy on 23 January 2017 added few details but did give some general indications of pointing towards models used in other Commonwealth countries⁸. The green paper is directed more to infrastructure investment as a driver for inward investment, than the control of investment in critical infrastructure. An early bellwether opportunity was passed up regarding a Sino-Australian consortium’s £5bn acquisition of National Grid’s gas distribution business in December 2016. Government officials side-stepped the

5 Hydrocarbons (Temporary Management Scheme) Regulations 2013

6 <https://www.gov.uk/government/news/secretary-of-states-decision-on-rwe-letter-one-transaction>

7 <https://www.gov.uk/government/news/government-confirms-hinkley-point-c-project-following-new-agreement-in-principle-with-edf>

8 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/585273/building-our-industrial-strategy-green-paper.pdf, see p.85 for a reference to qualitative “net benefit” test linked to economic growth in the immediate geographic area of an investment

issue as the review of investment rules for critical infrastructure announced by the Hinkley Point C decision, had not yet been completed⁹.

In simple terms, there is not yet a settled position. As the reform proposal of 17 October 2017 stated, the government continues to consult on reform.

What then might that reform entail?

Some models for a wider foreign investment control regime

Although competition authorities generally express a preference for a competition based system of merger control not taking into account industrial policy or non-competition considerations, in reality many jurisdictions retain the power to intervene on the grounds that a merger presents a threat to national security on a much wider basis than the UK. It is also notable that these governments have refined the criteria around how they exercise those powers, whilst competing to attract critical infrastructure investment.

“THE “CANADA MODEL” HAS BEEN CITED BY A NUMBER OF COMMENTATORS, AND SOME UK POLITICIANS, AS A POSSIBLE MODEL FOR THE UK FOREIGN TRADE MODEL IN THE FUTURE.”

The “Canada model” has been cited by a number of commentators, and some UK politicians, as a possible model for the UK foreign trade model in the future, following the signature of the EU-Canada *Comprehensive Economic and Trade Agreement* (“CETA”) on 30 October 2016¹⁰. Canada’s foreign investment control regime is the *Investment Canada Act*. This regime operates, albeit at reduced thresholds with its free trade partners, notwithstanding both the CETA and the North American Free Trade Agreement. The Canadian regime imposes lower thresholds for reviewing the acquisition of control of businesses involved in cultural industries, financial services, transportation, and uranium production. Although there is no specific provision on foreign state-owned enterprises (“SOEs”), debate around this subject caused a high profile bid by China Minmetals for Noranda, a major mining company, to fail in 2004. In its approval in December 2012 of Petronas’ C\$6bn acquisition of Progress Energy (an LNG export project), and CNOOC’s C\$12bn takeover of Nexen Inc. (an oil company), the government indicated a clear preference for private companies over SOEs, for minority SOE investments over control by SOEs, and a lower tolerance for SOEs acquiring control of leading companies in any sector of Canada’s economy. It also stated that foreign SOE control over oil sands projects would only be permitted “in exceptional circumstances”. This is a clear move to including industrial policy in the foreign investment control regime, albeit implemented in a manner directed to legal certainty and business confidence. This contrasts with a more ad hoc UK policy and to Australia, which was criticised for creating investment uncertainty as to which assets are “out of bounds”, leading to the 2017 Bill.

In Australia, the *Foreign Acquisitions and Takeovers Act 1975* and related regulations are administered by the Foreign Investment Review Board. This regime was substantially overhauled in 2015-2017, bringing in stricter reviews and penalties for infringement, with a particular focus on Australian food security and agricultural land¹¹. On 23 January 2017, the Australian government tightened security review scrutiny of critical infrastructure following concerns over the lease of Darwin Port to Chinese investors and the proposed Chinese takeover of the Ausgrid power network¹². The new Critical Infrastructure Centre will “provide

⁹ National Grid to sell 61% of gas business to Sino-Australian group, Financial Times, 8 December 2016

¹⁰ <http://ec.europa.eu/trade/policy/in-focus/ceta/>

¹¹ <https://firb.gov.au/resources/policy-documents/>

¹² “Australia bolsters protection of strategic assets”, Financial Times, 23 January 2017

greater certainty and clarity to investors and industry on the types of assets that will attract national security scrutiny". New Zealand has the *Overseas Investment Act 2005* administered by the Overseas Investment Office. This regime also grew out of controls on the foreign ownership of sensitive land and fishing grounds, and has evolved to cover foreign involvement in major business interests¹³.

These regimes shine some light on the possible direction of UK investment policy and the continuing review of the *Enterprise Act 2002* regime.

Concluding thoughts

No major economy wishes to become less competitive for foreign investment in critical infrastructure, as the UK government continually states. The Canadian example is instructive, in that a lurch towards protectionism and unclear regulatory criteria was successfully resisted. Following the China Minmetals decision in 2004, the Canadian government was under strong political pressure to introduce restrictive measures on foreign SOEs, which were tabled in a proposed Bill C-59 that was never approved. More specific and nuanced criteria were later introduced in conjunction with the approval of two major investments in critical energy infrastructure (CNOOC and Petronas), so acquisitions by SOEs which do not confer control may be subject to review for national security but are not reviewed under the Canadian SOE guidelines. When compared with the almost limitless jurisdiction of Committee on Foreign Investment in the United States regulators, and the much wider meaning of "control", the benefit of Canada's clearer regulatory guidelines is quickly apparent in the number of major energy transactions concluded. The UK now has the opportunity to enter into sector-specific agreements with other countries which may address concerns over "parity", whilst creating opportunities for UK investors in overseas critical infrastructure¹⁴.

The UK's critical energy infrastructure is not a closed system. Nothing symbolises this more than the gas and power interconnectors. Many of the core concepts of the EU Energy Union had their genesis in the UK: open access to infrastructure; and, more generally, competition in energy markets. These will continue in some form after Brexit, whether by dint of parallel implementation in UK legislation or through new pan-European energy structures¹⁵. The success of any expansion of UK investment control will be in maintaining clarity in being discrete from competition review under merger control. Although the cost and environmental risk of nuclear projects, and safety and environmental concerns in the North Sea, may justify a form of government control, regulators and governments also need to be receptive to solutions proposed by foreign investors to achieve these aims, to secure the benefits of competition and new investment.

One core aspect of the Hinkley decision was the creation of excess capacity in a capacity constrained power market. There is no market incentive to create this excess capacity but it has a social and wider economic value as cuts in supply are more costly to the economy as a whole than the cost of acquiring that capacity¹⁶. The government therefore seeks, through generous off-take guarantees, to impose conditions that safeguard this public investment. The Hinkley announcement states

13 <http://www.linz.govt.nz/regulatory/overseas-investment>

14 This approach is not an uncommon approach: "This Vision of post-Brexit trade puzzles experts", Financial Times, 22 January 2017. There are several examples: US nuclear energy agreements with India (permissive) and Iran (restrictive) to the EU rules-based agreements (e.g. EU-Azerbaijan agreement on energy cooperation; the Energy Community Treaty with Ukraine, Moldova, Turkey, Georgia and the non-EU countries of SE Europe).

15 The EU acquis on gas already applies in EFTA and the Energy Community, integrating energy markets in non-EU Europe.

16 www.dieterhelm.co.uk/energy/energy/greg-clarks-energy-agenda

that the new critical infrastructure investment framework will include (and will therefore not be limited to) nuclear energy. New transmission capacity, gas and power interconnectors and the next transportation fuel infrastructure are all affected.

A “net benefit to the UK” test could offer clear criteria around the nature of the investment being made and its benefit to the UK, rather than a focus on the nature of those able to provide the necessary size of investment (which may include foreign pension and wealth funds or state-owned enterprises). This might involve an assessment of the effect of the investment on: related economic activity; employment, the utilisation of local parts, components and services; and its contribution to the UK’s competitiveness. Such an approach may be more workable in the UK context, where there is already substantial foreign involvement in critical infrastructure, and is not obviously at odds with policy to date. The outcome will go to defining the growth parameters of the UK economy for years to come.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



COLIN GRAHAM
Partner
London

D +44 20 3314 6498
M +44 7725 218415
cgraham@wfw.com



PAUL DORIS
Partner
London

D +44 20 7814 8199
M +44 7718 700019
pdoris@wfw.com



JEREMY ROBINSON
Partner
London

D +44 20 3036 9800
M +44 7718 694613
jrobinson@wfw.com

Publication code number: 61135587v1© Watson Farley & Williams 2017

All references to ‘Watson Farley & Williams’, ‘WFW’ and ‘the firm’ in this document mean Watson Farley & Williams LLP and/or its Affiliated Entities. Any reference to a ‘partner’ means a member of Watson Farley & Williams LLP, or a member or partner in an Affiliated Entity, or an employee or consultant with equivalent standing and qualification. The transactions and matters referred to in this document represent the experience of our lawyers. This publication is produced by Watson Farley & Williams. It provides a summary of the legal issues, but is not intended to give specific legal advice. The situation described may not apply to your circumstances. If you require advice or have questions or comments on its subject, please speak to your usual contact at Watson Farley & Williams.

This publication constitutes attorney advertising.