

# Energy and Infrastructure Round-Up

Q2/Q3 2021

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While 2021 saw a quiet start for the infrastructure and energy sectors in Europe and the UK, due chiefly to the continuing pandemic and related issues, the market has come roaring back in Q2/Q3. From major M&A transactions in the energy sector to infrastructure fund closings to the headline-grabbing take-private of John Laing, dealmakers and investors have been very active. We have seen an uptick in the number of M&A deals, year over year, as well as a modestly increased focus on renewables.

Take a deeper dive into these and other timely topics in the latest edition of our *Energy and Infrastructure Round-Up*. And to discuss any of these developments and how they may impact your business, please reach out to a member of the Paul Hastings Energy & Infrastructure Team.



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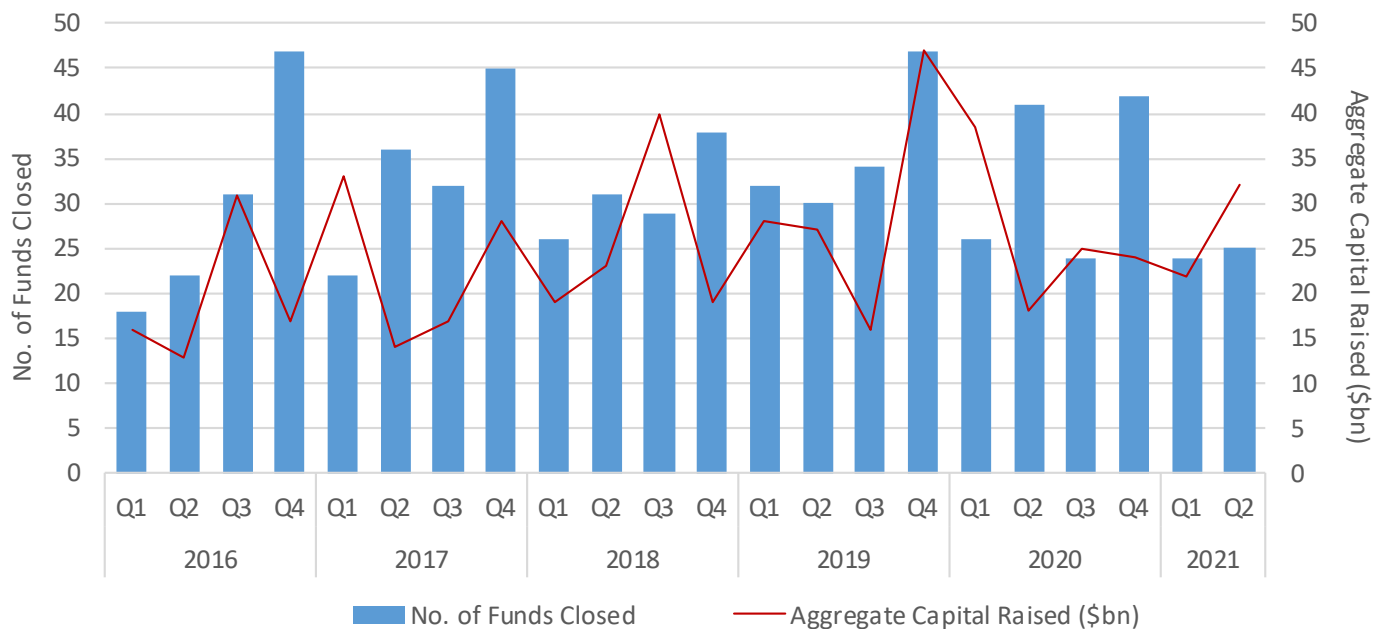
## Q2/Q3 2021 Energy and Infrastructure Round-Up

### 1. Market Activity

**Q1 through Q3 activity levels in 2021 compared to the same period in 2020:**

- 365 European M&A transactions in 2021 compared to 334 transactions in 2020
- 55% renewables in 2021 compared to 51% renewables in 2020
- No other sector exceeded 10% of market share in 2021 or 2020, except telecoms at 13% in 2020
- The most active European jurisdictions by deal count in 2021/2020 were UK (26% / 26%), Spain (16% / 14%), Italy (9% / 9%), France (5% / 15%) and Germany (5% / 7%)
- 125 refinancings have closed in 2021, as compared to 150 in the same period in 2020
- Renewables, transport and telecommunications were the most active sectors in the debt markets and the UK, Spain, Italy and France were the most active jurisdictions

Fig. 1: Global Quarterly Unlisted Infrastructure Fundraising, Q1 2016 - Q2 2021



Source: Inframation

Fig. 11: Number of Infrastructure Deals by Region, Q1 2016 - Q2 2021

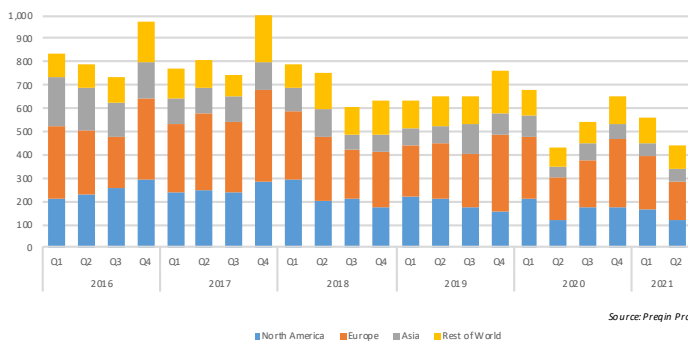
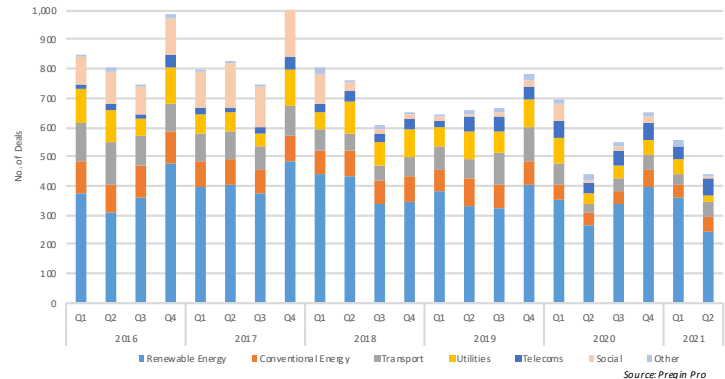


Fig. 12: Number of Infrastructure Deals by Sector, Q1 2016 - Q2 2021



### Paul Hastings Energy and Infrastructure Team

*As well as providing innovative legal solutions, we assist clients in the infrastructure, energy and natural resources sectors with their transaction strategy. We specialise in public and private M&A, acquisition and project finance as well as other structured corporate debt, and have advised extensively on a range of global cross-border transactions.*

## 2. Market Commentary

As we reported in our previous Q1 round-up, the infrastructure sector had a comparatively subdued start to 2021. However, the market has since come roaring back. There are many headline grabbing transactions, such as the 25x price that the APG consortium is reported to have paid for Stockholm Exergi. But the take-private of John Laing stands out. Not so long ago a joint bid by KKR and Equitix to invest in core infrastructure might have seemed an unlikely tie-up. However, both are marquee investors, KKR being a pioneer private equity fund and Equitix being the most successful infrastructure investor by deal count (203) built on the back of greenfield investments (as is the case with much of John Laing's portfolio). Clearly they each contribute significant financial and asset management expertise. But the transaction also neatly illustrates a number of other market trends:

- social infrastructure, comprising 77% of John Laing's portfolio, had been out of fashion but is now regaining market attention - partly as a result of Covid-19 putting it back in the spotlight;
- public markets, especially in the UK, appear to be undervalued;
- despite being a novel process for many infrastructure investors (see below), public to private transactions (which tend to involve fewer bidders) may be preferable to over-competed private auction processes;
- PPP/revenue concession based projects typically include indexed payment mechanisms, offering a hedge against the looming risk of inflation eroding investment returns;
- returns on core infrastructure can still be compelling, especially if the usual target IRR of >8% is rarely achieved by the market (as reported by Infraction recently); and

- a transition from regional to global investment strategies - with John Laing having a track record in Europe, North and South America as well as Australasia – to access markets with the most active greenfield and brownfield pipelines.



### 3. The Proposed New Corporate Sustainability Reporting Directive

On 21 April 2021, the European Commission published a proposal for a package of sustainability related regulatory reforms, including a proposal for a Corporate Sustainability Reporting Directive (the “**CSRD**”), which will replace the existing Non-Financial Reporting Directive (“**NFRD**”) and amend certain provisions of the Transparency Directive, the Audit Directive and the Audit Regulation. The CSRD aims to improve the quality, comparability and accessibility of corporate reporting on sustainability issues and will apply to a greater number of entities than the NFRD. The ultimate goal is that, in time, sustainability reporting will be in line with current financial reporting.

The NFRD requires EU “public interest” undertakings (i.e. EU listed entities, EU credit institutions, EU insurance undertakings and other EU undertakings that are designated as such by Member States due to their significant public relevance) with 500 employees on average over the relevant financial year and (a) a balance sheet total exceeding EUR 20 million or (b) a net turnover exceeding EUR 40 million, to report on sustainability related information including, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery. However, the NFRD lacks details as to the information that needs to be reported under this regime and does not mandate reporting standards to be used when reporting relevant information. Consequently, the levels and standards of reporting vary enormously between entities, making it difficult for investors and stakeholders to compare sustainability performance between different organisations. This lack of comparable information is a particular issue for financial investors and asset managers who are (or will be) required by the Sustainable Finance Disclosure Regulation (the “**SFDR**”) and the Taxonomy Regulation (“**TR**”) to disclose information regarding the sustainability of their investments (see our previous round up for further information on the SFDR and the TR). It is worth noting that financial market participants who are required to report information on their products under the SFDR are not excluded from reporting on their own businesses under the NFRD if they fall within the scope of the NRDF (the same will apply in regard to the CSRD when it comes into force). Disclosures under the TR in respect of sustainable investments also apply to those that are required to report under the SFRD and/or the NRDF (or, the CSRD when it comes into force).

The CSRD will significantly increase the number of entities that are required to report substantiality related information (under the NFRD approximately 11,000 entities are required to report, whereas, under the CSRD approximately 50,000 entities will be required to report). Unlike the NFRD which only applies to EU “large public interest” undertakings, the CSRD will apply to all EU “large” undertakings (whether listed or not) and all undertakings with securities listed on an EU regulated market (excluding listed micro-enterprises). For the purposes of the CSRD, an undertaking is a “large” undertaking if it exceeds on its balance sheet date at least two of the following: (a) a balance sheet total of EUR 20 million; (b) a net turnover of EUR 40 million; and (c) 250 employees on average over the financial year. The CSRD will also include much more detail (as compared to the NFRD) on the sustainability related information which is required to be disclosed and will provide that disclosures must be made in line with mandatory reporting standards which will be established by the European Commission.



The CSRD will require sustainability related information to be included in the management report of the relevant undertaking and will not permit disclosure in a separate document (as is currently permitted under the NFRD). Under the current regime, the auditors of the relevant reporting entity are required to confirm that the statement on sustainability issues required pursuant to the NFRD is included in the management report of that entity or in a separate document. However, under the NFRD, no audit is required in respect of the contents of such statement or the methods used by the entity for assessing and measuring sustainability impacts and risks. Sustainability related information reported pursuant to the CSRD will require a “limited assurance” by a statutory auditor and it is thought that in due course this may change to a “reasonable assurance” requirement. This (albeit limited) audit requirement is aimed at ensuring reported information is reliable and accurate.

It is expected that Member States will be required to implement the provisions of the CSRD into national law by 1 December 2022, large undertakings will be required to begin reporting under the CSRD for the financial year starting on or after 1 January 2023 and small and medium-sized listed undertakings will be required to begin reporting under the CSRD for the financial year starting on or after 1 January 2026. The CSRD will not have effect in the UK unless implemented by UK legislation.



#### *Action*

*Affected undertakings to review their policies for SFDR, TR and CSRD compliance.*

## 4. The Subsidy Control Bill

From 1 January 2021, the EU state aid rules ceased to apply to funding and other forms of support measures granted to businesses by UK public authorities (subject to limited exceptions). On the same date, the UK-EU Trade and Cooperation Agreement (the “**TCA**”) was implemented directly into UK law. Under the TCA, the UK committed to introducing its own domestic subsidy control regime, which respects certain key principles designed to ensure a ‘level playing field for open and fair competition and sustainable development’ between the UK and the EU. This was to address an EU concern that the UK should not be permitted to unfairly subsidise its businesses, or permit them to engage in anticompetitive practices that would not be acceptable under EU competition law rules, so as to give them an unfair competitive advantage when trading with the EU.

The framework for the UK subsidy control regime set out in the TCA is largely similar to the EU state aid regime, including that the definition of “subsidy” in the TCA is broadly the same as the definition of “aid” in the EU state aid rules. However, a key difference between the two regimes is that under the EU state aid regime, the default position is that aid needs to be notified to, and pre-approved by, the European Commission (subject to the general block exemption rule), whereas, under the TCA, the default position is that UK public authorities can grant subsidies provided that the proposed subsidies comply with certain key principles.

On 30 June 2021, the UK government published the Subsidy Control Bill (the “**Bill**”) which builds on the subsidy control regime outlined in the TCA while also introducing some new concepts. The Bill introduces a new limb to the definition of “subsidy” to include subsidies that have, or are capable of having, an effect on competition or investment within the UK, whereas, in the TCA the definition is limited to subsidies that have, or are capable of having, an effect

on trade or investment between the UK and another country or territory. This change to the definition of “subsidy” means that the proposed UK subsidy control regime will apply to subsidies that only have effect in the UK which is in line with the broader aim of protecting the UK internal market. In a similar vein, the Bill includes a new prohibition on the granting of subsidies on the condition that the entity in question relocates all or part of its existing economic activities from one region of the UK to another region, which is intended to avoid “subsidy races” between different areas of the UK.

As mentioned above, the backbone to the UK subsidy control regime is a set of key principles. A UK public authority must not grant a subsidy unless it is satisfied that the subsidy complies with these principles. The TCA sets out six principles and the Bill adds a seventh. The additional principle added by the Bill is that the beneficial effects of the subsidy in terms of achieving the specific policy objective should outweigh any negative effects, in particular negative effects on domestic competition or investment and international trade or investment. The Bill also includes further principles which will apply (in addition to the seven key principles) to subsidies granted to entities operating in the energy and environment sectors. It is expected that guidance on the application of these key principles will be issued in due course and that UK public authorities will have a statutory duty to follow such guidance.

The Bill provides for different levels of scrutiny before a UK public authority is permitted to grant a subsidy, with the level of scrutiny depending on the category of the subsidy. The Bill sets out four categories of subsidy, being: (i) low risk subsidies; (ii) “baseline” subsidies; (iii) “subsidies of interest”; and (iv) “subsidies of particular interest”. In respect of low risk subsidies, which are subsidies that are low risk of distorting competition, trade or investment, it is proposed that streamlined subsidy schemes be created for these subsidies. Where a streamlined subsidy scheme is available for a particular subsidy, before granting such subsidy the relevant UK public authority will only need to demonstrate that the subsidy meets the specific compliance criteria for the relevant scheme and will not need to assess the subsidy’s compliance specifically against the seven key principles. In respect of “baseline subsidies”, UK public authorities will be required to self-assess compliance of the subsidy in question against the seven key principles and will only be permitted to grant the subsidy if it complies with all seven principles. In respect of “subsidies of interest”, which are subsidies that are more likely to affect competition, trade or investment, including by reference to the value of the subsidies and the sector in which the intended beneficiaries operate, the UK public authority considering the grant of any such subsidy will have the option to make a voluntary referral to the Subsidy Advice Unit (the “SAU”) of the Competition and Markets Authority. If such a referral is made, the SAU will review the public authority’s assessment of the proposed subsidy against the seven key principles and issue non-binding advice as to how that assessment and the design of the proposed subsidy might be improved. In respect of the final category of subsidies – “subsidies of particular interest” – which are subsidies that are most likely to affect competition, trade or investment, the Bill provides for a mandatory referral regime. In accordance with the Bill, UK public authorities are not permitted to grant any subsidy of particular interest without advice from the SAU. It is thought that further details of what constitutes a “subsidy of interest” and a “subsidy of particular interest” will be set out in secondary legislation in due course.

The Bill will undoubtedly undergo a number of amendments as it makes its way through the Parliamentary process before it is enacted but it does give an indication of what the UK subsidy control regime may look like once the Bill becomes law. It is currently anticipated that the Bill will be enacted in Spring 2022.



#### Action

*Monitor status of the Bill as it progresses through Parliament and once enacted consider availability of funding.*



## 5. Resurgence of Infra P2P

The UK has seen a significant increase in the number of public-to-private transactions targeting listed businesses undertaken by private equity firms in the last 18 months. The total value of UK listed companies across all sectors purchased by private equity firms increased from £2.3bn in 2019 to £21.1bn in 2020, according to the accountancy group BDO. Furthermore, Dealogic's data shows this year has been the busiest start to a year for financially backed bids since 2012.

Infrastructure funds are increasingly at the forefront of this trend. In May 2021, KKR Infrastructure and Equitix announced the acquisition of British infrastructure investor John Laing in an agreed £2 billion takeover bid and private aviation group Signature Aviation was sold to a consortium of private equity firms in a £4.09 billion deal. In the Signature deal, Blackstone, Global Infrastructure Partners, and Cascade Investments combined to agree a joint bid with a 53 percent premium on the company's pre-bidding share price making it one of the London Stock Exchange's largest ever bid premiums for a take-private transaction. Augean, Aggreko, Applegreen and Calisen are further London-listed energy and infrastructure companies to have attracted private equity interest recently.

The amount of capital available to invest in infrastructure has been a factor in drawing away managers from pure private-to-private transactions. Privately held infrastructure funds raised \$102bn last year, for example, up from just \$34bn a decade earlier, according to figures from data provider Preqin. At the same time, depressed valuations of UK-listed companies can be found as the London market continues to suffer as a result of Covid-19 and Brexit, whilst the UK Government is promising a major increase in infrastructure expenditure of £600bn over the next five years.

In addition to the opportunities presented by general market valuations, some commentators point specifically to valuation dislocation between listed trading multiples and multiples paid in private transactions as the rationale for the rise in the number of public-to-private transactions. A comparison by listed infrastructure manager 4d Infrastructure of listed vs unlisted valuation multiples between 2015 and 2020 confirmed the view that the vast majority of private transactions occur at multiples towards the top end or above the range of listed valuation multiples.

In addition, the complexity of takeover bids, compressed mandatory bid timeline, the need for upfront transaction costs in bid preparation including the need for certain funds financing all provide a competitive first mover advantage for bidders compared to private auction transactions.



### Action

*In the current environment, financial sponsors and listed energy and infrastructure funds should consider their public bid and defence strategy and preparations.*

## 6. ESG Margin Ratchets on the Rise

With ESG being the buzzword of the 2020s, borrowers and lenders are increasingly looking to incorporate ESG margin ratchet provisions into their deals. Indeed, in 2021 so far, 40% of European syndicated loans have included such provisions, according to Reorg. For borrowers and sponsors, these provisions offer, amongst other things, reputational advantages, whereas for lenders the incorporation of ESG margin ratchets into their loan documents aids them in complying with their own ESG targets. With 128 firms (including the world's three largest asset managers, Blackrock, Vanguard and State Street Global Advisors) now having committed to the Net Zero Asset Managers initiative to achieve net zero greenhouse gas emissions by 2050 or sooner, the inclusion of ESG margin ratchet provisions is expected to become more widespread.

The ESG margin ratchet provisions provide for a decrease and/or increase in the margin payable, subject to compliance with relevant ESG targets. These provisions are usually set out in the loan agreement or in a side letter either at closing or post-closing. While a market standard is yet to emerge, compliance is usually measured annually rather than quarterly and is assessed with reference to either (i) a performance against a baseline ESG score given to the borrower by a third party ratings agency on the date of the loan agreement or first utilisation (the “**Closing Score**”), or (ii) various key performance indicators (“**KPIs**”) which can be absolute, pre-agreed targets or percentage improvements measured year-on-year against a baseline ESG score or metric which may be set by the borrower itself or by an independent third party. Borrowers have tended to push to set this baseline score/metric internally. In cases where it is more easily and objectively determined (for example, the number of women in management) this is likely to be uncontroversial. However, where, for example, the KPI is a reduction in greenhouse gas emissions, lenders may require that the score/metric is set in accordance with relevant protocols and/or verified by an independent third party.

Borrowers are required to make annual disclosures to the lenders in order to measure compliance. For loans that adopt the KPI metric, disclosure is usually in the form of a compliance certificate delivered by the borrower, whereas for loans where performance is measured against the Closing Score, borrowers are required to disclose the annual ratings report produced by the ESG rating agency appointed in the loan agreement or side letter. The latter, being externally assessed, may be preferable from a lender perspective, although lenders sometimes choose to require that any KPI compliance certificate delivered by a borrower is also independently audited by a reviewer with sufficient expertise, such reviewer typically being selected at the sole discretion of the borrower.

It is important to note that non-compliance with ESG provisions does not in itself trigger a default (absent a direct breach of use of proceeds clauses) but instead causes an increase (or disapplies a potential reduction) in the margin payable if such a mechanic is provided for in the loan documentation. Margin increases and decreases typically vary from - / + 5 bps to - / + 15 bps, with - / + 7.5 bps being most common in 2021, according to Reorg. As the inclusion of ESG margin ratchets becomes more widespread in the market, this range is likely to expand.



#### Action

*Reduce funding costs and enhance ESG credentials through incorporation of margin ratchets.*

## 7. Dutch court orders Shell to reduce its global carbon emissions by 45%

On 26 May 2021, the Hague District Court issued a ruling requiring Royal Dutch Shell plc, the parent company of the Shell group (“**Shell**”) to slash its global CO<sub>2</sub> emissions by 45% by 2030 (compared to 2019 levels). This not only applies to emissions generated directly by Shell but also emissions generated by its suppliers.

The order comes after proceedings were launched by a number of Dutch climate change groups in the Dutch courts. They argued that Shell, whose total greenhouse gas emissions in 2019 were level with that of Russia (the world’s fourth largest polluter), was acting in breach of the Dutch population’s human rights by not adhering closely enough to the Paris Agreement’s aims to limit the rate of global warming. Despite all 196 signatories to the Paris Agreement being nation states, the judge was of the view that Shell, as a company, had a responsibility to act in line with the aims of the global climate policy enshrined in the Paris Agreement. Consequently, the court found that Shell’s own target of reducing greenhouse gas emissions by 20% by the end of the decade was not sufficient to uphold the standard of care in Dutch tort law owed by Shell to the people of the Netherlands.

This is widely seen as the first time a court has ordered a non-nation state to align its policies with the Paris Agreement. Furthermore, in applying the principle of *locus delicti* – that is, the concept that a claim may be brought under the law of the jurisdiction in which damage is suffered – the court was able to determine that even Shell’s carbon emissions produced outside the Netherlands were capable of breaching the open standard of care owed by Shell to the Dutch people, because such activities contributed to global climate change which, in turn, would be harmful to people in the Netherlands. This judgment therefore potentially sets a precedent for Dutch courts to have extremely far-reaching powers when it comes to imposing obligations at a global level on some of the industry’s biggest polluters. Shell has announced it will appeal the decision.



#### Action

*Analyse and mitigate ESG linked litigation risk.*

## 8. Carbon capture

Carbon Capture Usage and Storage (CCUS) has been a topic on the fringes of the infrastructure sector for some years. However, it has recently been overshadowed by hydrogen, which is capturing far more market attention as a potential investment proposition – see below. In practice the two are interlinked, as hydrogen and CCUS are likely to be developed on an integrated basis around energy and industrial hubs. Both hydrogen and CCUS are included in the UK Government’s Ten Point Plan for a Green Industrial Revolution published in November 2020, which forms part of the wider framework aimed at achieving Net Zero by 2050. Whereas these objectives will primarily be achieved through a transition to renewable energy, the purpose of CCUS is to prevent or reduce carbon emissions primarily from industrial processes and conventional power generation point sources or through capturing carbon directly from the atmosphere (so called “Direct Air Capture”). The economic incentive to develop CCUS is in part a function of the pricing of carbon emissions which is a separate, but linked, area of policy development. The Ten Point Plan includes a commitment to deploy CCUS in a minimum of two clusters by the mid-2020s and four clusters by 2030 with an ambition to capture 10MtCO<sub>2</sub>/year by 2030.

CCUS to date has largely been confined to a few projects in the power sector. However, heavy industry is responsible for approximately 20% of global CO<sub>2</sub> emissions. The UK Government has been developing new business models for CCUS which, in addition to carbon pricing, provide more incentive to develop new projects. The current revenue proposals include a privately financed RAB model for the transport and storage component of CCUs and a separate mechanism similar to contracts for differences (CfDs) for the power sector and heavy industry. As was the case with renewables, the hope is that the level of Government support that is required will decline over time as the use case and technology develops. Subsidies were reduced or removed and CfD prices declined dramatically in the electricity market once an operating track record was established in offshore wind and in other sub-sectors.

Another major milestone to CCUS becoming an investible proposition was launched in May 2021. The Government published a white paper which set out the initial detail on the Carbon Capture and Storage and Fund (CIF). The allocation of £1bn to CIF was confirmed at the November 2020 Spending Review. The CIF will primarily support capital expenditure on the Transport & Storage (T&S) networks and Industrial Carbon Capture (ICC).

There’s no shortage of potential CO<sub>2</sub> storage in the UK – 70 gigatonnes according to one estimate, which represents capacity for 190 years based on 2019 emission figures. Saline aquifers and depleted oil and gas reservoirs provide most of that capacity. However, there are residual concerns around leakage risk, particularly for saline aquifers but also the condition and suitability of some of the oil and gas reservoirs. Getting comfortable with these risks depends,



in part, on the regime by which liability will ultimately pass, after a number of years, from the CCUS project to Government. The carbon capture technology can also be used, as an alternative to storage, to create supplies of CO<sub>2</sub> for various products and services, such as synthetic fuels or chemicals.

Although there has been an increase in CCUS projects under development in recent years, as a large-scale commercial investment proposition it remains at relatively early stages. Further policy and legislative developments, including tax and incentive frameworks will be needed to accelerate the pipeline of investible projects. However, the speed at which these are being announced suggests this is an area to monitor closely for opportunities to invest, once sufficient predictability has been achieved, at an early stage in this emerging infrastructure sub-sector. Increased focus reflects the critical role that CCUS is expected to play as an offset mechanism in energy production and industrial processes, as well as the production of hydrogen and decarbonisation of long distance transport. The scale of the potential investment opportunity is illustrated by the International Energy Agency's estimate that, in order to limit a temperature rise to a maximum of 2 degrees Celsius, 100 gigatonnes of carbon dioxide must be stored by 2060.



#### Action

*CCUS represents a significant potential investment opportunity, given its importance in decarbonising conventional energy and industrial processes on which we are expected to depend for many years to come.*

## 9. UK Government Hydrogen Policy

On 17 August 2021, the UK Government published its long awaited hydrogen strategy for the UK (the “Strategy”), which sets out further details on how the UK Government intends to achieve its goals of 5GW of low carbon hydrogen production capacity in the UK by 2030, the UK being net zero by 2050 and establishing a thriving hydrogen economy in the UK. The Strategy sets out a broad range of policy and investment commitments, and a roadmap to developing a UK hydrogen industry. Set out below are some of the key takeaways from the Strategy:

**Holistic approach:** The Strategy takes a holistic approach and recognises the need to establish both supply and demand for low carbon hydrogen as well as developing the necessary infrastructure for a successful hydrogen economy, including networks and storage. As part of this, the Strategy details steps to encourage industrial use of low carbon hydrogen, including the phasing-out of carbon intensive hydrogen production.

**Twin track approach:** The Strategy takes a “twin track approach” supporting the production of both “blue” hydrogen and “green” hydrogen. Blue hydrogen is hydrogen produced from natural gas with the carbon emissions from this process being captured, used and stored (“CCUS”). Green hydrogen is hydrogen produced from water (via electrolysis) using electricity generated by renewable energy. The Strategy envisages that the production of blue hydrogen will take priority during the 2020s with the production of green hydrogen scaling up in the 2030s when the hydrogen economy and necessary infrastructure are better developed.

**Carbon standard:** The Strategy supports a variety of production methods to enable the UK to meet its low carbon hydrogen production targets. To enable an assessment of the carbon intensity of hydrogen produced by different methods, a carbon standard will be introduced whereby if the production method meets the requisite greenhouse gas threshold (which is yet to be confirmed) the hydrogen will be classified “low carbon”. This standard, which is currently under consultation, will be key in determining which hydrogen projects are entitled to receive government support.

**Hydrogen Business Model:** The development of a sophisticated hydrogen economy in the UK will require significant investment and the Strategy acknowledges that government funding in hydrogen to de-risk early projects will be key to unlocking private investment in this area. According to the Strategy, private sector investment in hydrogen projects could exceed £4bn by 2030. A key consideration for private investment in the hydrogen sector will be ensuring adequate returns versus risk. In support of this, the UK Government has launched a consultation on a proposed business model to support hydrogen production (the “Hydrogen Business Model”), with submissions due by 25 October 2021. According to the Strategy, the UK Government plans to finalise the Hydrogen Business Model in 2022 to enable first contracts to be allocated in Q1 of 2023.

The Hydrogen Business Model envisages that the UK Government will manage market price risk and the volume/demand risk for early investors in the hydrogen sector. The model proposed in the consultation contemplates payments to producers with a similar structure to the contracts for difference schemes used for UK renewable electricity and envisages that a producer producing hydrogen meeting the “low carbon” standard (as discussed above) will be paid a variable premium being the difference between: (a) a reference price set at the higher of: (i) the natural gas market price; and (ii) the hydrogen sale price actually achieved; and (b) an agreed “strike price”, subject to adjustment to ensure that the producer is paid a higher unit price if there are lower volume demands.

The proposal also suggests support from the UK Government will reduce both over the life of the relevant contract and also over the course of future allocation rounds as the hydrogen economy develops. It is not currently clear what the duration of the contracts for difference will be. It appears that the contracts for difference will be allocated on a bilateral basis by the UK Government subject to a project meeting required conditions rather than operate on an open auction basis. The Government has indicated that the envisaged hydrogen price and volume support mechanism can work alongside other incentives that are applicable to projects, including capital grants and Renewable Fuel Transport Obligations.

**Funding:** The Strategy commits to the launch of a Net Zero Hydrogen Fund in 2022, which is currently under consultation. It is proposed that this fund will provide capital grants totalling, in aggregate, £240m to support development activities and construction costs relating to new-build hydrogen projects.

**Regulatory framework:** The Strategy recognises the need for a regulatory framework for hydrogen but does not set out in detail what this might look like. A better understanding of the proposed regulatory framework will be an important factor for potential investors in the hydrogen sector. It is anticipated that this regulatory framework will be implemented during 2022 to enable first contracts to be allocated in Q1 of 2023.

**Conclusion:** The Strategy is an important step to the UK’s transition to a carbon neutral economy and establishing the UK as a key player in the global hydrogen economy, and is a clear signal of the UK Government’s commitment to hydrogen. The outcome of the consultation on the Hydrogen Business Model and the Net Zero Hydrogen Fund should provide further clarity on support from the UK Government for investment in this sector. Initial market reaction to the Strategy suggests that the market views the Hydrogen Business Model as favouring large scale blue hydrogen applications rather than more modular green hydrogen projects and it will be interesting to see the results of the current consultation exercise.



#### Action

*Consultation submissions to be made by 25 October 2021. Keep watching brief on results of consultation.*

## 10. Green Signal for European Rail

UK rail has been one of the most active sectors in Europe in recent months. This follows significant disruption and emergency support for the industry after a collapse in passenger numbers due to Covid-19. It also follows an extended period of regulatory review causing some investor uncertainty.

The UK led the way in Europe to privatisation of railways – with mixed success. The most recent plans for a major overhaul of the industry have been in the pipeline since the Williams Review commenced in 2018. The long-awaited White Paper: “Great British Railways - The Williams-Shapps Plan for Rail” was published in May 2021. The commitments outlined in the paper have broadly been welcomed by the rail industry.

Both rolling stock owners (ROSCos) and train operating companies (TOCs) may have felt relief that the proposals were not more radical. There had been speculative talk in recent years of more wholesale nationalisation, despite the significant compensation costs that would have meant for taxpayers. That being avoided, and the expectation that the impact of the reforms on the UK ROSCos will be benign, appears to have triggered recent M&A processes for both Porterbrook and Angel Trains. Dalmore and Generation Capital acquired a 30% stake in Porterbrook, whilst PSP and Amber upsized their existing investment in Angel Trains by acquiring AMP’s managed 51% stake.

The headline changes in the White Paper were (i) the introduction of a new overarching rail body, Great British Railways, which will subsume Network Rail and take responsibility for a more integrated railway network and (ii) a change to the franchise system so that in most cases the primary revenue for the TOCs will be service fees and incentives under new Passenger Service Contracts, rather than the TOCs taking revenue risk for passenger numbers as was previously the case. But the Williams Review also included a swathe of new proposals and investment priorities, including investment to move more freight onto the railway (as a green initiative) as well as a simplification and digitalisation of ticketing, including more flexibility such as Pay as You Go.

Great British Railways will be responsible for collecting fares, owning the infrastructure and managing the network and will also set most fares and timetables. The body will have a national responsibility, but will also be made up of regional divisions, with budgets and delivery responsibility. The privatisation of British Rail in the 1990s certainly resulted in significant investment in the railways. However, it also came at the expense of significant fragmentation and a disconnect between various parts of the industry and network, as well as a number of failed rail franchises. Moreover the fact that the Government had to bail out the collapsed franchises (often after significant dividends had already been paid) illustrated that the transfer of economic risks had not been effective under the old model and did not necessarily represent good value for money. In theory the new model ought to address that risk, with TOCs operating the services using a framework which is based on the London Overground and Docklands Light Railway. However, the Williams Review also makes clear that the Passenger Service Contracts will not follow a one size fits all approach, including the length of contract award and, in some cases, there will be scope for sharing of fare revenues as rail passenger numbers recover. Tender processes have resumed, which will be the first test of whether new investor expectations can be achieved.

Likewise there are significant changes to the rail industry in France, with a continuation of the trend to market liberalisation which is in part driven by the need of SNCF, the state operator, to reduce its debt against a backdrop of significant capex requirements to renew assets. In that context, April saw a consortium of DWS and CDPQ enter into talks with SNCF as the preferred bidder for ERMEWA. ERMEWA owns and leases about 42,000 industrial railcars and a fleet of 60,000 tank containers. The consortium is rumoured to have bid around EUR 3.2bn including debt, in what was understood to be a well contested process. In Germany, a consortium of Swiss Life Asset Management and Vauban acquired Aves One, which is a freight wagon lessor, with an EV of approx. EUR 1bn at roughly 12x EBITDA. If there is one consistent trend in this activity it is the focus on freight as an expected area of growth under both the Williams Review and in the context of the European M&A processes.





#### Action

*After the uncertainties of Covid-19 and regulatory review, this is an endorsement of private sector investment in the rail sector and should encourage further M&A and potential investment opportunities in new franchises and freight businesses in the UK and Europe.*

## 11. Additional Paul Hastings Energy and Infrastructure Insights

Set out below are links to our previous publications covering the EMEA infrastructure sector during 2020/2021.

### **Navigating New Paths to Growth – A story of Resilience and Agility, March 2021**

Energy and infrastructure is traditionally viewed as a non-cyclical or counter-cyclical asset class. The year 2020 provided a good opportunity to put that theory to the test. We have taken feedback from our clients and looked at market data to gauge the resilience of fundraising, transaction levels and sub-sector performance. We also identify likely drivers of growth in a post Covid-19 investment environment. [Click here](#) to read our chapter on Energy and Infrastructure, and our key takeaways.

### **Infra Investment Resilience - Testing Pandemic Immunity**

Recent changes to risk perception, perceived debt and equity appetite for certain infrastructure asset sectors and the growing ESG movement look set to outlast the pandemic. In a roundtable we hosted in partnership with Proximo Infra, infrastructure debt and equity investors debated lessons from the pandemic, ESG compliance and building a diversified portfolio in a post-pandemic infrastructure investment landscape. You can read a write-up of the roundtable by [clicking this link](#).

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