PAUL HASTINGS

Q1 2021 Energy and Infrastructure Round-Up

1. Activity and Trends

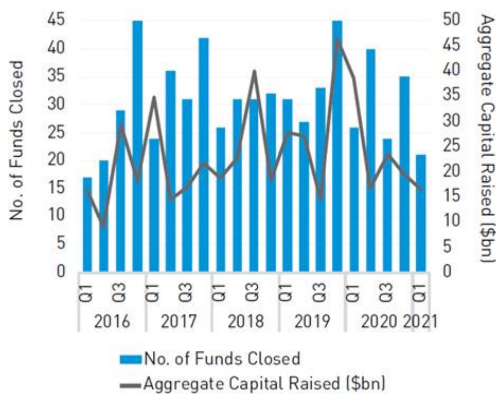
Overview Q1 2021 vs Q1 2020 – M&A and Refinancing in EMEA

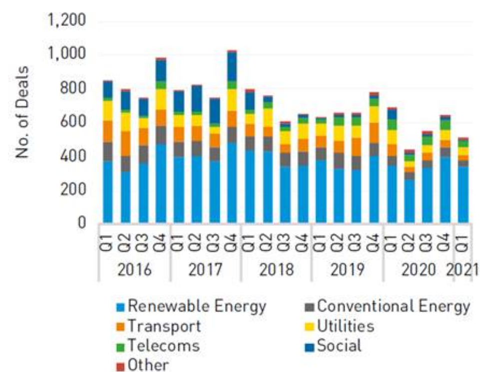
- Deal activity in the energy and infrastructure sector was down significantly during Q1 2021. Transaction levels reduced 13%, with 154 closed transactions for Q1 2021 compared to 177 closed transactions for Q1 2020. More significantly, the total value of deals in the sector declined by approximately 40% for the quarter.

- Renewables remained the dominant sector with 92 closed transactions in Q1 2021 (compared to 85 closed transactions in Q1 2020). The next highest sector was transport with 18 transactions in Q1 2021 (compared to 14 transactions in Q1 2020) but with deal value falling by approximately 40%. Contrary to forecast trends, telecoms transactions in Q1 2021 also declined to approximately a third of the value for Q1 2020.

- The most active jurisdictions during Q1 2021 were the UK with 46 transactions (compared to 48 transactions in Q1 2020), Spain with 20 transactions (compared to 23 transactions in Q1 2020), France with 13 transactions (compared to 24 in Q1 2020), Italy with 14 transactions (compared to 15 in Q1 2020), Germany with 7 transactions (compared to 11 in Q1 2020) and Poland with 7 transactions (compared to 6 in Q1 2020).

- Compared to M&A, the number of standalone refinancings reduced as a proportion of transaction activity to 18% (compared to 35% for Q1 2020).





Sources: Inframation and Preqin

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. ESG investment

87 firms with nearly $37 trillion in assets under management ("AUM") have now signed up to the Net Zero Asset Managers initiative, committing to support the goal of net-zero greenhouse gas emissions by 2050 or sooner. This includes the world's three largest asset managers, Blackrock, Vanguard and State Street Global Advisors, with the 87 signatories now managing nearly 40% of total AUM across the globe. Under the initiative asset managers commit that, within a year of joining, they will set an interim target for 2030 to manage a proportion of assets in line with the attainment of net zero emissions by 2050 or sooner. Firms also commit to review their interim target at least every five years, with a view to ratcheting up the proportion of AUMs covered until 100% of assets are included.
https://www.netzeroassetmanagers.org/

Action

Sponsors that are not already signatories to consider joining the initiative.

3. EU's Sustainable Finance Disclosure Regulation and EU Taxonomy Regulation

On 10 March 2021, new rules on sustainable investing in the European Union were introduced. Key parts of the EU's Sustainable Finance Disclosure Regulation ("SFDR") have now come into force, with the full range of new rules being phased in over the coming months. The new rules are intended to channel capital flows towards sustainable investments with a view to supporting the UN's Sustainable Development Goals and the Paris Climate Change Agreement. The rules set out disclosure obligations in relation to Environmental, Social, and Governance ("ESG") issues for asset managers and advisers. The rules apply principally to businesses located in the EU. However, UK and US managers, amongst other "financial market participants" and "financial advisers", will be caught by the new SFDR rules where they market products into the EU.

The SFDR is part of a package of EU reforms relating to sustainable investing. This also includes the Taxonomy Regulation, which comes into force in January 2022. The focus of the SFDR is on transparency and disclosure to investors of the approach that a firm takes to sustainability issues in its investment and advisory processes. The Taxonomy Regulation provides a legal framework to be followed in screening investments to determine whether they are "environmentally sustainable". Neither the SFDR nor the Taxonomy Regulation require firms to integrate ESG considerations across their activities. However, firms will need to disclose their approach to these issues and where products are promoted as sustainable, justify this in order to mitigate risks of so-called "green washing".

Although the new rules do not mandate adoption of ESG investing across the board, the transparency and "comply or explain" provisions in the SFDR will undoubtedly exert indirect pressure on firms to adopt aspects of ESG in their investment and advisory processes. In addition to this, firms will need to take clients' ESG preferences into account when providing investment advice or managing an investment portfolio as part of the suitability processes. It will, therefore, become increasing untenable for firms to avoid sustainable investing issues as a result of these new requirements.

Obligations to disclose information apply at a legal entity level and also in relation to specific financial products. Currently these apply to pre-contractual and website disclosures. Fund managers are required to classify their products under Article 6 (no ESG objective or related marketing), Article 8 (by describing ESG characteristics and

the methodology applied) or Article 9 (having ESG as an objective). Where products promote sustainability or have sustainable investment as an objective, additional disclosure obligations arise including with respect to periodic reporting in relation to the relevant product. The key obligations cover: (i) Integration of sustainability risks in investment processes; (ii) Principal adverse impact disclosures; (iii) Remuneration Policies; (iv) Products promoting environmental or social characteristics; (v) Products with a sustainable investment objective; and (vi) Periodic reporting for Article 8 and Article 9 financial products.

Article 9 funds will have the most stringent data reporting requirements on their sustainability impact. However, as the details of that regime have not yet been finalised, the uncertainty has led many funds to opt for lesser classification under Article 6 or Article 8. For many infrastructure funds it is not tenable to elect for Article 6 as most investors now expect to see some ESG disclosures.

Action

Sponsors to ensure compliance with classification and reporting requirements, which will affect both fundraising and investment strategies.

4. LIBOR Transition

Infrastructure debt borrowers now face the daunting prospect of having to migrate their LIBOR loans to new risk free rates by a new year-end deadline. Unlike many leverage loans, most floating rate infrastructure debt is also hedged. Therefore managing the risk of a basis mismatch, including the timing of the rate switch for both products, is a further challenge for infrastructure borrowers.

Loans: On 5 March 2021 the UK Financial Conduct Authority (the “FCA”) announced the cessation dates on which LIBOR will cease, or will cease to be representative, for 35 specified tenors and currencies (sterling, US dollar, Japanese Yen, Euro and Swiss Franc). In most cases that date will be 31 December 2021, but for 1-month, 3-month and 6-month US dollar LIBOR the date is 30 June 2023. The FCA will consult on the continuation of synthetic rates for the currencies and tenors, including three and six month sterling, where the rate will cease to be representative. Any such continuation of synthetic rates is expected only to be available to so called “tough legacy” contracts, rather than for use generally. It remains to be seen whether long-dated infrastructure debt borrowers can expect to be able to rely on the availability of these synthetic rates if they fail to achieve the transition.

Hedging: ISDA also announced that the FCA’s statement constituted a pre-cessation trigger for the purposes of the definition of Index Cessation Event. This has two significant consequences under Supplement 70 to the 2006 ISDA Definitions (the “ISDA Fallbacks Supplement”) and the ISDA 2020 IBOR Fallbacks Protocol (the “Protocol”) for all LIBOR rates. First, it means that the “Spread Adjustment Fixing Date” for the relevant LIBOR settings is 5 March 2021, meaning the spread adjustment to compensate for the difference between LIBOR and the new risk-free rate (“RFR”) has been fixed. Secondly, it means that all ISDA contracts incorporating the ISDA Fallbacks Supplement or Protocol will fallback (i.e. switch) to the new adjusted RFR, including the spread adjustment, on 1 January 2022 or (in the case of US dollar LIBOR), 1 July 2023. Note however that the ISDA Fallbacks Supplement or Protocol must have been incorporated into the relevant ISDA agreement in order for the fallback provisions to apply.

The above announcements will no doubt accelerate the process of LIBOR transition to the relevant RFR (e.g. SONIA, SOFR, SARON, TONAR) under loan and hedging agreements. The process for doing so will in part depend on whether the amendment provisions of the relevant loan agreement have already been adapted to include specific rate switch provisions provided by the LMA or otherwise. If so, and depending on which version of the LMA or other modified terms apply, the switch may occur automatically without requiring any further amendment or consent (as is expected under the LMA's most recent exposure draft provisions) or may require an additional consent for the transition to become effective but only (in the case of a syndicated loan) on a Majority Lender basis. As noted above, part of such exercise will involve aligning the terms and timing of the transition of loans and hedging to manage the basis mismatch risk.

Action

Borrowers and lenders to implement LIBOR transition process before year-end. Sponsors to monitor compliance by portfolio companies.

5. English governing law and jurisdiction clauses after Brexit

Governing law: Following the UK's withdrawal from the EU, both the English courts and courts in the EU will continue to recognise a choice of English law as the law governing a contract and disputes relating to it. This is because the Rome I Regulation (which applies to contracts) and the Rome II Regulation (which applies to the governing law of non-contractual obligations) are of universal application, irrespective of EU membership. Both regulations have been incorporated into English law under the European Union (Withdrawal) Act 2018 and will continue to be recognised within the EU.

Choice of jurisdiction: Choice of jurisdiction and enforcement of judgments is less straightforward following the UK's withdrawal from the EU. There is an increased risk of parallel proceedings in the UK and the EU and more uncertainty about enforcement of judgments across those jurisdictions. That is because neither the Lugano Convention nor the Recast Brussels Regulation (EU Regulation No 1215/2012) currently applies to the UK. Whilst the UK has acceded to the Hague Convention, this only applies to exclusive jurisdiction clauses and has fewer signatories than the Lugano Convention. The UK's accession to the Lugano Convention has not been ratified, and there are reports that the EU is opposed to the UK's membership. Unless and until the UK does accede, we expect to see much more use of exclusive jurisdiction clauses for English law contracts in order to fall within the Hague Convention. Whether the Hague Convention applies to asymmetric jurisdiction clauses is untested under English law. Therefore lenders in particular are foregoing the customary flexibility of a finance contract with an asymmetric jurisdiction clause (which gives only the lenders a non-exclusive choice of jurisdiction) and are instead using exclusive jurisdiction clauses in order to be certain that the finance contract will fall within the Hague Convention.

Action

Lenders to consider choosing exclusive jurisdiction of English courts, rather than customary asymmetric jurisdiction. All market participants to be aware of increased uncertainty in relation to submission and enforcement of judgments.

6. National Security and Investment Bill Update

Since its introduction on 11 November 2020, the National Security and Investment Bill (the "**Bill**") has been subject to a number of consultation processes and amendments, many of which have limited the scope of the extremely wide reaching foreign investment regime initially proposed for the UK. On 29 April 2021, the Bill received Royal Assent and is expected to come into force later this year, possibly as early as the autumn.

A significant recent development is that the notification threshold in respect of the acquisition of a shareholding or voting rights in a target (to which the regime applies) has been increased from 15% to 25%. It is thought that this increase in the notification threshold was in response to concerns that a 15% threshold was unnecessarily low and would not only put off foreign investors interested in acquiring minority interests but would also create a huge amount of work for the Department of Business, Skills and Industrial Strategy ("**BEIS**") in terms of reviewing and approving the large number of mandatory filings expected to result from a 15% threshold (as many as 1,800 per year). Despite this increase in the notification threshold, the Secretary of State will retain the power to review and challenge any acquisition by a foreign investor that does not meet the 25% threshold in circumstances where it is reasonably suspected that the deal could result in the foreign investor acquiring "material influence" over the target.

The mandatory filing regime detailed in the Bill applies to 17 sectors, being advanced materials, advanced robotics, artificial intelligence, civil nuclear, communications, computing hardware, critical suppliers to Government, critical suppliers to the emergency services, cryptographic authentication, data infrastructure, defence, energy, military or dual-use technologies, quantum technologies, satellite and space technologies, synthetic biology and transport, subject to qualifying thresholds based on criteria such as revenue, market share or capacity. Based on the initial definitions of these sectors, a wide range of stakeholders expressed concerns that many were too board. To address these concerns, the Government undertook a consultation process on the sector definitions. On 2 March 2021, the Government published its response to this consultation and the definitions for a number of these sectors were reduced in scope, thereby further reducing the number of transactions to which the mandatory filing regime will apply.

While this new foreign investment regime is not yet in force, when it comes into force there will be a five year look back period starting on 12 November 2020 (the day after the Bill was introduced) during which the Government can "call in" and scrutinise any transaction which has not been notified if there is a reasonable suspicion that such transaction may give rise to a national security risk. This new legislation is therefore relevant for transactions that are happening now. In respect of current deals, the only mechanism by which parties can seek to avoid a future call in is through an informal screening process offered by BEIS. Under this new foreign investment regime, when in force, the Government will have wide reaching powers in regard to transactions which fail to comply with the new regime, including imposing fines and penalties and, most extreme of all, declaring non-compliant deals null and void. Furthermore, breach of the legislation will be a criminal offence.

Action

Market participants to monitor the date on which this legislation will come into force and how it affects M&A transactions in practice. Sponsors to consider implications for bid and divestment strategies.

7. Budget – Qualifying Plant and Machinery and Freeport Status

Qualifying Plant and Machinery: In a move to spur post-pandemic growth, the Government announced in its 2021 Budget a temporary capital allowance "super-deduction" which will apply to investments in qualifying new plant and machinery made between 1 April 2021 and 31 March 2023. This means that companies now investing in assets previously qualifying for capital allowances at the 18% main rate will instead be able to reduce their taxable profits for the year by 130% of the cost of the new asset. Those investments previously qualifying for allowances at the 6% special rate will now benefit from a 50% first-year allowance.

The impact is therefore considerable. However clients should be aware of certain exceptions. The super-deduction will not be available for expenditure incurred under contracts entered into before 3 March 2021, even where the expenditure is incurred after 1 April 2021. It will also not be available for used or second-hand assets. Plant and machinery used wholly within a ring fence trade will be excluded from the super-deduction, as they already have a 100% allowance, but assets used only partly in a ring fence trade will qualify for a 100% first-year allowance for the same period.

Freeports: The Chancellor also confirmed there will be eight new freeports in England (Liverpool City, Teesside, Thames, Felixstowe & Harwich, Solent, Plymouth, Humberside and East Midlands Airport), with more to come. Freeports allow companies to import goods VAT and tariff-free, with tariffs only then being payable if the goods are moved elsewhere in the UK. Goods imported into freeports and then exported overseas do not incur any tariffs. Pre-Brexit, such privileges would have contravened the EU's rules on state aid. In a string of further measures announced to be in place until 30 September 2026, freeports will benefit from an enhanced structures and buildings allowance of 10% on the construction of new, and renovation of existing, non-residential structures and buildings, effectively achieving full tax relief on the cost of the building after only 10 years, as opposed to the standard 33 years and four months (where tax relief is ordinarily achieved at 3%). There will also be enhanced capital allowances of 100% on the cost of qualifying plant and machinery for use within freeport sites as well as stamp duty and land tax relief on purchases of land and buildings within a freeport.

Action

Sponsors to factor into M&A strategy and asset management by ensuring portfolio companies take advantage of available reliefs and exemptions.

8. National Infrastructure Bank

The Treasury has confirmed that the new infrastructure bank will have two core policy objectives (i) tackling climate change and helping the UK meet its net zero emissions target by 2050 and (ii) to support regional and local economic growth. Up to £22bn of initial funding/capital will be available, in the form of £5bn of equity, up to £7bn in debt, and up to £10bn of guarantees under the UK Guarantee Scheme. £4bn of the debt and equity will be allocated to local authority lending with loans being made available to local authorities for strategic projects of at least £5m at a rate of gilts + 60bps. The sector focus will include clean energy, transport, digital and water and waste, consistent with the National Infrastructure Strategy.

The last similar initiative was the Green Investment Bank ("GIB"), which was established in 2012 and subsequently sold by the UK Government to Macquarie in 2017. In the same period the UK Government also made available the guarantee scheme for infrastructure projects ("UKGS"). Many in the industry were concerned that GIB and UKGS were crowding-out private sector capital from investments in UK infrastructure, including renewables. There were also criticisms of the sale of GIB. Those views are debated, but it has led some to question the need for a new National Infrastructure Bank only four years after the sale of GIB. However, the decision to establish the bank comes at a time when the European Investment Bank ("EIB") will be providing far less (if any) finance to UK projects, having previously made significant investments in the UK at attractive funding rates. Despite previous concerns about market distorting effects of GIB, UKGS and EIB, there remains a potential role for the National Infrastructure Bank to catalyse and gap-fill early stage funding for new and developing technologies that are required for the UK to meet its net zero emissions commitment and to invest in regional growth. To the extent that the private sector is able to provide sufficient capital to meet these objectives, especially given the high levels of liquidity in the market, then the National Infrastructure Bank will not need to commit funding. Perhaps more pressing at this stage is regulatory frameworks and funding models in the UK that support those emerging technologies and regions.

Action

Market participants to monitor developments and consider use of any additional funding that is made available.

9. Ofwat and Ofgem determinations and disputes

Ofgem published its final determinations for gas distribution, gas transmission and electricity transmission service operators for RIIO-T2 in December 2020. This reduced the Weighted Average Cost of Capital ("WACC") to 2.81%. By contrast, the WACC for the current price control is between 3.8% and 4%. By March 2021, the four UK gas distribution networks had announced they were challenging aspects of Ofgem's determinations. This follows a similar challenge by water companies to the price controls for the period 2020-25 published by Ofwat in December 2019. In March 2021 the UK Competition and Markets Authority increased the WACC for the water companies from 2.96% (the rate that had been proposed by Ofwat) to 3.2%. This is still a significant reduction from the 4.7% WACC that applied in the prior period, but investors welcomed the decision as mitigating the UK regulatory risk that is perceived to have increased in recent years.

The regulatory actions and disputes come at a time of increased M&A in the sector. SSE is reportedly selling its 33.3% stake in Scotia Gas Networks and Southern Water is raising new equity in order to deleverage the business. It also follows the recent sale of Western Power Distribution and the announcement of the proposed sale of National Grid Gas, owner of the national gas transmission system.

Action

Sponsors and lenders to consider as part of M&A and asset management strategies and assessment and mitigation of UK regulatory risk.

10. Offshore Wind Leasing Round

On 9 February 2021, the Crown Estate announced the results of the Invitation to Tender Stage 2 process for its Offshore Wind Leasing Round 4, which makes available areas of the English and Welsh seabed for developing almost 8GW of capacity. Notably, this was the first time in the European market that investors were able to bid (on an uncapped basis) the annual option fee they were willing to pay for the development rights. In previous years, option fees had been set by the Crown Estate at a fixed annual amount. With relatively little capacity on offer (2010's Round 3 offered 32 GW) and increasing demand for the rights to develop offshore wind sites, the introduction of its new price-driven bidding system secured the Crown Estate a considerable £879m per year (or £111m per GW per year) in option fees for up to a maximum of 10 years.

Developers will therefore be incentivised to minimise the period in which they are paying the option fee and promptly complete all of the necessary steps, such as securing planning permission and a grid connection, before being able to exercise the option and enter into a 60 year lease with the Crown Estate. The successful bidders in the Crown Estate auction were RWE Renewables with two areas of 1,500 MW each, a consortium of EnBW and BP with two areas of 1,500 MW each, a consortium of Total and Macquarie's Green Investment Group with one area of 1,500 MW and Offshore Wind Limited with one area of 480 MW.

In light of the Crown Estate's announcement, Crown Estate Scotland (which is split from the Crown Estate and follows Scottish government policy) halted its ongoing auction for rights to the Scottish seabed in order to reconsider its standard pricing strategy, which instead puts a cap on the amount developers can offer in option fees. Following a review, Crown Estate Scotland announced on 24 March 2021 that it will increase the cap on option fees tenfold.

Action

Market participant awareness of competition for renewables assets and cost of UK offshore wind development.

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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