

ISSUE 13: JUNE 2014

# EnergySource

**UKCS acquisitions and disposals:  
reaching the finish line**

by Julia Derrick and Grace Rackham

**Bribery and corruption: implications  
for energy companies**

by Tom Cummins and Prateek Swaika

**Business and human rights:  
more reasons to “know and show”**

by Jennifer Zerk

**Mining in Africa:  
trends in regulatory reform**

by Martin Kudnig and Tim Kennedy

**Renewing French hydroelectric  
concessions: much ado about nothing**

by Michel Lequien, Jacques Dabreteau and Olivia Le Baube

**UK energy market: competition  
inquiry on the front burner?**

by Neil Cuninghame and Emily Clark

**The heat is on: RHI support for CHP plant**

by Antony Skinner and Justyna Bremen

**African oil & gas and resource  
nationalism: a swinging pendulum**

by Nicolas Bonnefoy and Jerome Basdeo

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# AN OVERVIEW OF THIS ISSUE

We are delighted to introduce the first issue of EnergySource for 2014, our biannual publication in which we cover a range of legal and transactional issues relevant to the energy sector from our offices across the globe. In this issue, we will be looking at:

**UKCS ACQUISITIONS AND DISPOSALS** Parties involved in UKCS upstream asset acquisitions and disposals need to be mindful of the fact that a deal is not completely done once the SPA is signed. Julia Derrick and Grace Rackham discuss some of the common issues that can arise in the run-up to completion of a transaction and suggest some practical tips to help minimise completion delays.

**BRIBERY AND CORRUPTION** Regulators around the world are becoming more proactive in tackling corruption and in co-operating with each other. Tom Cummins and Prateek Swaika take a look at how the UK, US and Germany remain at the forefront of anti-bribery enforcement action, how other countries in developed and emerging markets are beginning to follow their lead, and what implications this has for the energy industry.

**BUSINESS AND HUMAN RIGHTS** Jennifer Zerk, former Ashurst lawyer and now a freelance writer and consultant in the field of business and human rights, tackles the question of whether businesses are getting to grips with human rights issues.

**REGULATORY REFORMS IN AFRICAN MINING** Recent reforms of mining laws in African nations have led to a movement away from regimes regarded by many as “investor friendly”. However, the importance of a stable regulatory framework in attracting foreign investment has also been recognised. Martin Kudnig and Tim Kennedy discuss the various trends emerging across Africa.

**FRENCH HYDROELECTRIC CONCESSIONS** The first tenders for hydroelectric concessions in France are still to be issued and the Government has recently cast fresh doubt over whether the market will be opened to new players in the foreseeable future. Michel Lequien, Jacques Dabreteau and Olivia Le Baube consider the current state of play.

**UK ENERGY COMPETITION INQUIRY** Energy markets regulator Ofgem has proposed to make a market investigation reference to the Competition and Markets Authority in respect of the supply and acquisition of energy in Great Britain. Neil Cuninghame and Emily Clark look at the political and regulatory context for the investigation proposal as well as its implications.

**RENEWABLE HEAT INCENTIVE** Currently, renewable CHP plants are able to receive support for their heat output in the same way as for their electricity output. With the phasing out of this option, Antony Skinner and Justyna Bremen explore how the RHI can no longer be ignored by power project developers.

**AFRICAN OIL & GAS AND RESOURCE NATIONALISM** Although a continent rich in oil and gas resources, African governments have struggled to achieve the right balance between their own interests and meeting those of investors. Nicolas Bonnefoy and Jerome Basdeo consider the issues of key concern for both parties.

We hope that you find EnergySource useful and enjoy reading this issue. Please let us know if you have any feedback or if there are any topics that you would like us to cover in future editions.



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## UKCS ACQUISITIONS AND DISPOSALS:

# Reaching the finish line

by Julia Derrick and Grace Rackham

There is a common preconception that the “difficult” part of an upstream oil and gas acquisition or disposal is getting to the point where an asset sale and purchase agreement (SPA) is signed between a seller and a buyer. While the commercial negotiations and documenting the agreed sale and purchase terms can be both challenging and time consuming, the process for completing the transaction, and effecting the legal transfer of assets, can be an even more challenging and lengthier process. Parties often underestimate the amount of work and time it takes to complete a transaction.

This article considers, in the context of upstream oil and gas asset acquisitions and disposals in the United Kingdom Continental Shelf (UKCS), some of the common issues which can arise in the run-up to completion of a transaction, and includes some practical tips to help minimise completion delays. Consideration of these issues early on in the sale process, and preparing accordingly, should not only help effect a more timely completion, but can also assist a buyer to ensure a trouble-free exit if and when it decides to on-sell the assets.

### **Common issues in completing UKCS upstream asset acquisitions and disposals**

Completion delays may arise for a variety of different reasons. Anticipating the areas which are likely to affect completion can assist buyers and sellers in minimising issues once the SPA has been signed. Common reasons for, and sources of, completion delays in the UKCS are set out below.

#### **Mature assets with a complex history and complex arrangements for commercialisation of production**

Many UKCS assets have been in production

for a significant length of time, and often share transportation and processing facilities. This can create a number of different issues, which include:

- It is not always easy to identify the relevant joint operating agreement which applies to the asset being transferred. Many of the older joint operating agreements started their lives as a joint operating agreement covering a large area and numerous licences. Over time, licences and blocks in the UKCS have been subdivided and therefore the relevant joint operating agreement will have been

amended (but not necessarily restated or replaced) to apply as a separate agreement to different blocks or areas as the asset develops and is redesignated. Often there is confusion as to the areas to which the relevant joint operating agreement currently applies, which is compounded by inconsistencies in naming blocks or assets and incomplete records.

- When dealing with complex assets it is not always straightforward to identify what the current asset documents are. Even if the original asset documents are identified, for more mature assets these will likely have been amended and supplemented many times without restatement. When copies are located, these can often be incomplete drafts rather than fully executed versions, which in turn leads to delays in identifying the final and binding version of the governing documents, particularly when conflicting drafts are presented by different co-venturers.
- It is not uncommon for the transfer process to reveal that certain asset documents have expired but the present parties have continued to act as if such documents are in force without any written formalisation of this arrangement. This can make it challenging for the parties preparing the necessary completion documents to identify which documents still relate to the asset, and the current parties may need to amend, extend or enter into new agreements prior to the transfer.
- Issues may arise in trying to identify all relevant third parties whose consent is required and who need to execute the relevant completion documents in order to effect the transfer of the asset, particularly when working with older asset agreements or those asset agreements which include non-contracting parties to the master deed.

#### **Historic asset transfers may not have been properly effected**

When preparing the relevant completion documents for an asset transfer, the starting point for most parties will commonly be the relevant completion documents for the immediately preceding asset transfer. This has the benefit of reducing the amount of work and time needed to get a first draft into circulation, and, in theory, all the current seller needs to do is to update the relevant completion documents with any new affected petroleum agreements which have been entered into since the date of



the last transfer. However, caution should be taken, as historic completion documents may be inaccurate, and reliance on these can therefore cause problems for future transfers. For example, historic completion documents may contain incorrect percentage interests of the continuing participants, or historic parties or agreements. If there are previously executed (but incorrect) completion documents, parties will often need to divert time to identify where the errors first appeared and enter into rectifications prior to the current transfer.

#### **The assignment and transfer provisions in the asset documents are often ambiguous**

Having identified the relevant governing documents for an asset, more issues can arise when considering the assignment provisions in the relevant asset documents, as it is often not clear what, if anything, needs to be done to effectively novate the agreement from seller to buyer. Frequently, the assignment provisions in UKCS agreements are either missing or not clearly drafted, and so it is not always easy to determine the exact procedure which needs to be followed. Areas where confusion often arises are:

- Pre-emption and transfer provisions in joint operating agreements and unit operating agreements are not always easy to interpret, and the current parties may not be in agreement as to which terms prevail (particularly in documents which have been amended over time) or how provisions should be interpreted. Issues can arise if a buyer and a seller are in agreement that no pre-emption provisions exist or that the pre-emption provisions are not applicable to the transfer in question but, during the completion process, a co-venturer asserts that it has a pre-emption right.

- Many contracts relating to assets are entered into by the operator of the asset for, and on behalf of, the participants to that asset and the individual parties are not signatories to the agreement. The assignment provisions in these documents can often be unclear as to what, if anything, a non-operator party has to do in order to transfer its interest in the agreement. The correct approach for transfer will depend on the terms of the particular contract. However, when the transfer provisions are not clear, there does not appear to be one agreed approach among UKCS participants. When transferring a non-operated interest in an asset, some participants take the view that, for the avoidance of doubt, it is better to include operator-to-operator agreements in the completion documents. However, other participants prefer to exclude operator-to-operator contracts if the assignment provisions are such that they do not expressly require the document to be novated, in order to reduce the number of documents to be transferred. While it is more time consuming, including all operator-to-operator contracts in an execution deed can have certain benefits, as it: (i) allows for all co-venturers to agree on those agreements which are current and may flush out historic agreements which are no longer relevant; (ii) provides a clear record of agreements relating to an asset on which the parties can rely in the future; and (iii) provides a buyer with a more complete index of the documents it should receive from the seller on completion.
- Asset documents often contain linkage provisions in their assignment

provisions which provide that, on a transfer of an interest in a UKCS licence, a corresponding transfer of interest must happen in another licence, infrastructure asset or other asset document. This can complicate matters and create completion delays, particularly if the acquisition or disposal is in relation to a package of assets which are intended to be transferred individually as soon as the conditions precedent for the relevant asset are satisfied. Given the number of third parties often involved, arranging for all linked assets, infrastructure and affected petroleum agreements to be ready for completion at the same time can be challenging. If there is one outstanding consent to the first asset in the sequence of transfers, this can cause substantial delays for all assets.

### **The process for obtaining third party consents can be time consuming**

Obtaining all the necessary third party consents to the transfer can significantly delay the completion process. Some third parties may have little incentive to review the completion documents quickly or within the timeframes envisaged by the seller and the buyer, while others may seek to use the completion process as a bargaining tool or leverage to achieve their own commercial objectives. For example, a party may seek to withhold consent to a transfer until a field-wide decommissioning security agreement is put in place.

### **Multiple transfers of the same asset or assets with overlapping asset documents may occur at the same time**

UKCS asset transfers happen with great frequency and different assets often either share infrastructure or affected petroleum agreements, such as transportation or pipeline proximity agreements. It is, therefore, common for multiple transfers to be happening at the same time which cover the same assets, infrastructure, and affected petroleum agreements. A sequence of completions needs to be agreed, as the sequence will determine the relevant entities which need to be party to the completion documents. Delays may be incurred when a sequence of completions has been agreed, but where a third party, for whatever reason, is slow in providing its consent to the first completion, which in turn prevents all other completions in the sequence from occurring until such consent is received.

## **Practical tips for ensuring a more streamlined completion process**

It is not always possible to take steps to avoid completion issues, and much will depend on the particularities of the assets involved, the commercial objectives of the parties and the deal timetable. Similarly, even if best practice is followed and issues are anticipated and addressed well in advance of the completion process, it is not possible to anticipate and address every potential source of completion delay. However, there are certain steps which, if practicable in the circumstances, can be taken to achieve a more streamlined completion process.

### **Steps which can be taken before any sale process commences**

#### **Maintenance of complete and up-to-date records of asset documents**

One of the tasks which is required to be performed during a sale process is to ascertain which documents currently relate to and govern the relevant asset. If practicable, parties with an interest in an asset should maintain a complete and organised internal database of current agreements (and all relevant amendments and novations) and a record of those which have been terminated. Parties who are able to achieve this will more easily be able to identify the relevant asset documents and respond to any future buyer's due diligence queries if and when they come to sell the asset.

#### **Proper consideration and clear, unambiguous drafting of assignment provisions in any new asset documents**

There is often a tendency to consider assignment and transfer provisions in asset documents as "boilerplate". However, as outlined above, unclear and ambiguous assignment provisions can create real problems and lead to delays on the sale of an asset. In a sale process, it is too late to do anything about missing or unclear assignment provisions. Therefore, in anticipation of any future sales, when drafting and entering into new contracts, parties should pay proper attention to the intended application of any assignment provisions, and the process for transferring an interest in the contract.

### **Steps which can be taken during a sale process, before an SPA is signed**

#### **Thorough due diligence process**

When acting as, or for, a buyer, where time and budget constraints permit, the benefits

of a thorough due diligence process cannot be underestimated. Not only does this provide the obvious benefit of familiarising the buyer and its team with the asset and its associated benefits and liabilities, but also provides verification from the start of a transfer that all relevant asset documents have been provided by the seller and that there are no gaps in title. This will save time when negotiating and agreeing the list of interest documents to be contained in the SPA, and the affected petroleum agreements to be novated in the execution deed or other completion documents.

#### **Drafting completion documents in parallel with the SPA**

Rather than agreeing and executing the SPA before drafting the transfer documents, it may be preferable (where time and resource constraints permit) for the seller and buyer to work together in parallel with the negotiation of the SPA to agree the form of execution deed or other relevant completion documentation. As soon as the SPA is executed, the seller is then able to circulate to all relevant third parties the completion documents for their review. This should start the often long and time consuming process of acquiring third party consents as early as possible and should assist in minimising the period between signing and completion.

### **Steps which can be taken during the completion process, after an SPA is signed**

#### **Use of the UKCS master deed and the execution deed**

The master deed is part of the legal framework of UKCS asset acquisitions, developed by the Progressing Partnership Working Group, a subset of the Pilot Taskforce, as a response to often lengthy negotiations on asset acquisitions and the variable pre-emption provisions which exist in UKCS asset operating agreements. The master deed applies to parties who are signatories to the master deed, known as "contracting parties", and provides for the standardisation of: (i) existing pre-emption provisions; and (ii) transfer arrangements through the use of the UKCS set form execution deed. This helps to streamline the completion process for UKCS acquisitions and disposals as follows:

- While pre-emption provisions are no longer permissible in UKCS joint operating agreements (as of the 20th UKCS Licensing Round), pre-emption provisions still remain in historic operating agreements and, as mentioned above, can cause



interpretation issues and delays to a completion process. The master deed acts by obliging contracting parties to read any existing pre-emption provisions in line with the master deed new pre-emption arrangements, which provide that all pre-emption provisions are limited to a maximum 30-day pre-emption period, thereby helping to clarify pre-emption provisions and potentially reducing the period during which a party may claim its pre-emption right.

- Most asset transfers in the UKCS where there are a large number of documents to be novated now use the master deed's execution deed. This process standardises the transfer mechanics and also helps to reduce the complexity around signature, as it authorises the UKCS administrator of the master deed (currently LOGIC) to enter into execution deeds on behalf of any contracting party. Use of the execution deed and co-ordinating the process with LOGIC also allows parties greater certainty around the timing of completions. However, as mentioned above, issues can still arise during the execution deed process when acquiring the signature of non-contracting parties to the master deed. Where non-contracting parties are parties to only a few agreements which relate to the underlying asset indirectly, it may be preferable to remove such agreements from the execution deed and transfer these separately outside of the execution deed process to mitigate delays to the main asset transfer.

**Avoidance of over-reliance on previously executed completion documents (which may be incorrect) and thorough checking of each completion document (whether you are the seller or a continuing participant)**

It is important for each party (whether the entity transferring its interest in an asset or a third party whose consent is required to the transfer) to check thoroughly that any execution deeds or completion documents conform with its own records of the asset contracts. This ongoing check between co-venturers should assist with the maintenance of a complete record of governing documents, prevent historic errors in transfer documents being perpetuated and provide a more reliable precedent for any seller to use if it decides to sell its interest.

**Good communication between sellers of the same asset or of different assets which share infrastructure or affected petroleum agreements**

Good communication between sellers is vital to ensure that it is clear from the start of a transfer process the order in which each seller's transfer will occur so the completion documents can be drafted to list accurately the remaining participant at each relevant transfer's completion date. Normally, the party which commenced its transfer first will take priority. If the execution deed process is being used, once an execution

deed is uploaded to the administrator (LOGIC), it is not possible to amend the execution deed and change the order of the transfers without withdrawing it first. It is therefore important to assess when drafting the execution deed whether there are any anticipated delays to receipt of third party consents, or circumstances surrounding the asset which will delay completion. Following this assessment, the execution deeds can then be put in the most appropriate order.

**Conclusions**

Although the suggestions outlined above may help to streamline a completion process, the reality is that participants often do not have the time or resources to carry out many of them. Also, participants often do not envisage exiting an asset in the near future, and thus do not conduct their affairs with a future sale in mind. A decision to dispose of an asset is often made at relatively short notice. Additionally, while steps can be taken to mitigate problems, it is virtually impossible to avoid any sort of delay altogether.

However, an awareness of the issues and their potential effect on completion timetables can at least help both sellers and buyers be realistic in their expectations, take adequate precautions and build into their SPAs appropriate provisions (and longstop dates) for dealing with completion delays.



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## BRIBERY AND CORRUPTION:

# Implications for energy companies

by Tom Cummins and Prateek Swaika

Regulators around the world are becoming more proactive in tackling corruption and in co-operating with each other. Although the UK, US and Germany remain at the forefront of anti-bribery enforcement action, several other countries, in developed and emerging markets, are beginning to follow their lead.

Enforcement authorities are using the full range of tools at their disposal, including deferred prosecution agreements<sup>1</sup>, to deter companies against future misconduct and it is expected that “sector-based sweeps” will become increasingly common. The energy industry is likely to be the focus of such a sweep.

The UK’s Bribery Act 2010 (Act), which came into force on 1 July 2011, provides the most comprehensive anti-bribery legislation to date with a wide territorial reach. For an offence to come within the scope of the Act, it must have been committed in the UK, or, if committed outside the UK, the offender must have a close connection with the UK. Specifically, the Act applies if the offence was committed by a UK citizen, a person usually resident in the UK, or a company with its registered office in the

UK. Senior officers of a company that has engaged in bribery can also be prosecuted for the offence. UK energy companies, most of which are likely to have transnational business activities, will be caught by the Act.

The Act makes it illegal to bribe private individuals and government officials, and, significantly for companies, includes an offence of failing to prevent bribery by associated persons. Such an association may arise from being a contractor, supplier, distributor or (as tends to be more common in the energy sector) a joint venture partner. As prosecutors do not have to prove knowledge or complicity, a company can be on the hook for bribery committed by an agent or an employee even if it was unaware of the bribe.

### Recent anti-bribery developments

The UK, following the implementation of the Act, has joined the US and Germany as one of the leading jurisdictions seeking to tackle bribery and corruption. Following the enactment of recent legislation, US-style deferred prosecution agreements have also become available to prosecutors in the UK from 24 February 2014. The Serious Fraud

Office (SFO) is actively pursuing various investigations following on from its first prosecutions under the Act last year.<sup>2</sup>

US regulators too have remained active. In 2013 alone, they conducted 27 investigations. Two of the resolutions reached by the regulators involved international companies in the energy sector. The fines levied in these cases made the Foreign Corrupt Practices Act 1977 (FCPA) fines’ top ten list of all time.

Brazil has introduced new anti-corruption legislation, the “Clean Companies Law”, which became effective at the beginning of this year. This legislation prohibits bribery of Brazilian and foreign public officials and significant penalties can be incurred by Brazilian companies guilty of foreign or domestic bribery. Its jurisdictional reach extends to Brazilian subsidiaries of foreign parents and bribery of non-Brazilian companies that takes place in Brazil. A compliance culture is

<sup>1</sup> Deferred prosecution agreements in the UK are voluntary arrangements reached between prosecutors and companies in instances where the company commits economic crimes such as fraud, bribery offences under the Bribery Act 2010, and money laundering. This agreement may enable a company to avoid a criminal conviction if it complies with a set of agreed terms and conditions, such as payment of financial penalties, compensation of victims, appointing corporate monitors to oversee the implementation of a compliance programme and/or the payment of costs.

<sup>2</sup> The SFO’s first prosecution under the Act commenced in September 2013 with the trial of four employees from biofuel investment promoter Sustainable AgroEnergy. They were charged in August 2013 with conspiring to conduct a £23m fraud operation in relation to the promotion and selling of biofuel investment products to UK investors. Three of the accused are also charged with making and accepting a financial advantage contrary to the Act.



encouraged, as it makes companies liable for the actions of their employees and agents. It also encourages self-reporting and co-operation by offering reductions in fines of up to two-thirds.

China is also increasingly focusing on tackling corruption and its enforcement actions – often involving high-profile government officials – routinely feature in the media. Foreign corporations have also been targeted, with GlaxoSmithKline becoming the first company to be criminally prosecuted for commercial bribery. The oil industry in particular is being targeted, with several oil industry executives detained and investigated, including a former chief of China Petroleum Corp. Whether this is the beginning of a sustained anti-corruption campaign remains to be seen, but companies doing business in China need to take note.

Other countries that have recently passed or extended existing anti-corruption laws include Bahrain, India, Italy, Russia and Spain, and others that are considering doing so include Germany and the UAE. Oman has also seen an increase in enforcement action, with the recent detention of Oman's National Gas Company's chief executive for suspected bribery, and the trial in November 2013 of the head of the tenders committee at Oman's state-run Petroleum Development Oman for taking a bribe.

Given the first EU anti-corruption report earlier this year, which found that bribery is costing Europe's economy £100bn a year, it is likely that we will see further action among

EU Member States. France, for example, is already calling for tougher anti-bribery national legislation to be put in place.

Levels of international co-operation between regulators is also on the rise, as can be seen in the Siemens AG case.<sup>3</sup> The case was initially opened by German prosecutors, but the US subsequently became involved as a result of Siemens' listing on the US stock exchange. The fine is still the largest FCPA penalty to date, of US\$800m. An additional €395m was fined in Germany. The French authorities' co-operation with the US has also led to a fine of nearly US\$400m being levied against a French energy company.

At the request of the US, following an FBI investigation, Austria arrested a Ukrainian energy magnate for allegedly paying bribes and forming a criminal organisation.

UK and US authorities have been working closely together for some time now. The case of DePuy International, which concerned bribes paid to Greek doctors, is a case in point. The bribery was discovered after the company was bought by Johnson & Johnson who reported it to the US authorities, who in turn reported it to the

SFO, which resulted in fines of £33m in the US and just under £5m in the UK.

Innospec<sup>4</sup> is notable for the international plea bargain reached and for which the SFO was heavily criticised by the English courts. The plea agreement followed more than two years of negotiations with the company by the SFO, the US Department of Justice and the Securities and Exchange Commission.

### Focus on energy sector

A 2012 study found that the oil and gas industry was subject to the most prosecutions for bribery in the UK<sup>5</sup>. Of the 26 completed cases surveyed, oil and gas made up nearly one-fifth of prosecutions.

At a regulatory conference in 2013, SFO Director, David Green QC, warned that the SFO would focus on sector sweeps with its enhanced intelligence-gathering function. Referring to Transparency International's Bribe Payers Index<sup>6</sup> (the Index) and dealing with the question of where the SFO would look first, Mr Green stated, "*I would look at sectors that are most vulnerable [to economic crime], such as construction and public contracts, oil and gas.*"

<sup>3</sup> In December 2008, Siemens AG settled a wide-ranging FCPA investigation involving at least 4,200 allegedly corrupt payments totalling approximately US\$1.4bn over six years to foreign officials in numerous countries in relation to transactions such as an infrastructure project in Argentina, telecommunications projects in Bangladesh and Nigeria, the installation of electricity lines in China, construction of power plants in Israel, design and construction of municipal transit systems in Venezuela, and the sale of medical devices in China, Russia and Vietnam.

<sup>4</sup> Between 2002 and 2006, Innospec bribed senior government officials of Indonesia, totalling approximately US\$8m, to secure contracts for the supply of a fuel additive. This led to Innospec being fined US\$12.7m (£8.3m) as part of a global settlement agreement between Innospec and the UK & US authorities, and the extradition to the US of its former CEO (who agreed to pay US\$229,000 to settle allegations of FCPA violations).

<sup>5</sup> <http://tinyurl.com/pyr6a7w>

<sup>6</sup> <http://bpi.transparency.org/bpi2011/>

Starting with construction, which was reported by the Index to be the most corrupt, Mr Green said he would work his way through the sector list, including oil and gas and other extractive industries. These sectors are therefore likely to become the subject of in-depth investigations by the SFO.

The focus on the energy sector is, however, unsurprising. The Index, which ranks the likelihood of companies from 28 leading economies winning business abroad by paying bribes, found that perceptions of the frequency of foreign bribery by country and business sector have on average seen no improvement since it was last published in 2008. Sectors that ranked at the bottom of the Index included utilities, oil and gas, power generation, and transmission and mining. These sectors are characterised by high-value investment and significant government interaction and regulation, both of which provide opportunities and incentives for corruption. The most common form of bribery in these sectors is perceived to be companies using improper contributions to high-ranking officials with the intention to secure influence over policy, regulatory and/or legislative decisions.

### Recommendations for energy companies

The provisions of the Act are wider than the FCPA's, to which many companies in the oil and gas industry are already subject. In particular, the Act prohibits bribes paid to private individuals as well as government officials and facilitation payments. Companies with compliance programmes that are currently tailored to the FCPA should therefore ensure they satisfy the requirements of the Act.

As UK companies are automatically subject to the Act, those companies with subsidiaries abroad will have to implement "adequate procedures" should they wish to have a defence to the corporate offence of failing to prevent bribery being committed on their behalf. Therefore, UK parent companies working with subsidiaries abroad should adapt their anti-bribery programme so that it extends to their entire group, regardless of the country where the subsidiaries are located.

In addition, energy companies should consider adopting the various measures set out in Figure 1, in order to strengthen their anti-bribery and corruption procedures. Such measures will not only assist

## Figure 1 – Recommended anti-bribery and corruption measures

- The company board, in consultation with its shareholders, should decide policies and political contributions.
- Political contributions and lobbying should be included in corporate reporting.
- Detailed records of all transfers made to governments and local communities should be maintained on a country-by-country basis.
- Bribery and corruption risks should be assessed across the company's entire supply chain. Comprehensive bribery and corruption risk assessment should be carried out with consideration given to the type and location of projects undertaken so that the specific risks faced are identified and managed.
- Appropriate due diligence should be undertaken to evaluate prospective contractors and suppliers to ensure that they have implemented effective anti-bribery programmes.
- The company's anti-bribery policies should be made known to contractors and suppliers and they should be contractually required to implement equivalent standards.
- Existing communication and training programmes should be reviewed to ensure that the desired corporate culture is achieved on the ground.
- Persons working in high-risk jurisdictions should receive increased levels of training to effectively combat the increased risk of bribery.
- Companies should consider joining, and actively participating in, collective anti-corruption initiatives and multi-stakeholder processes at the sectoral level.
- Payments to consultants should be reviewed and approved at a senior level, including the payment of expenses.
- Expenses such as corporate entertainment should be monitored carefully, with particular attention paid to the specific recipient, context and timing of the proposed gift or hospitality.
- Whistle-blowers who experience or witness bribery and corruption should be empowered through robust whistle-blower policies and procedures.
- Be alert to risk from joint ventures. When entering into a joint venture, or any other agreement with a third party, the underlying contractual documentation should state that all parties will comply meaningfully with the provisions of the Act, and provide that the agreement between the parties may be terminated if one of the parties undertakes an action that is not in accordance with the Act. Similarly, "evergreen" contractual representations and warranties should be given by all parties to the joint venture that state that the parties have not, and will not, undertake any action that is contrary to the Act.
- Businesses should allow for extra time in their project timelines, which may be needed if foreign government officials are not forthcoming with the licences and approvals, due to the (legal and correct) refusal to make any facilitation payments.

companies in defending against actions brought by the SFO, but will also ensure that any potential for bribery and corruption is identified and eliminated at an early stage.

### Conclusion

International co-operation and intelligence sharing in order to prevent bribery and corruption is only going to increase, and this in turn increases the likelihood of

companies getting caught. The implications of this renewed global focus on anti-bribery enforcement are challenging for many companies in the energy sector. Organisations that are involved in projects in high-risk jurisdictions need to be even more hands-on in implementing anti-bribery measures. All companies should review their risk profile and anti-bribery programmes to ensure these are adequate.

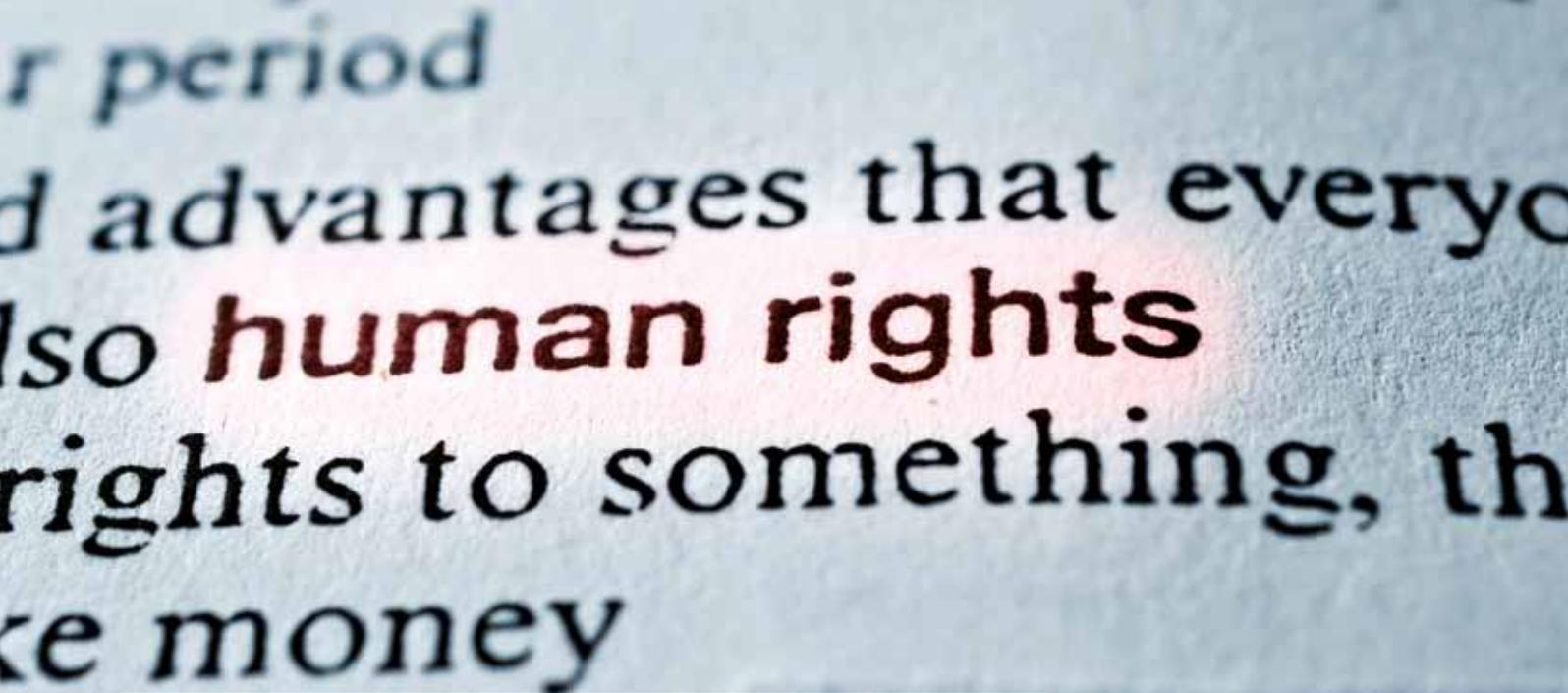


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## BUSINESS AND HUMAN RIGHTS:

# More reasons to “know and show”

by Jennifer Zerk

Are businesses getting to grips with human rights issues? The Second UN Forum on Business and Human Rights, held in Geneva in December 2013, provided a valuable opportunity to take stock of progress being made towards implementation of the UN Guiding Principles (see box on page 11) and to mull over some of the challenges we still face. The event was attended by over 1,700 representatives of business, government and civil society. Well represented, as ever, were the oil and mining industries – sectors that have, for the past 20 years or so, been on the front line of the business and human rights debate.

There are many reasons for this. While these industries are associated with positive human rights impacts (e.g. by supporting development and the generation of wealth), the risks of being involved or implicated in adverse impacts are particularly high. These risks can arise directly from extractive, refining or transportation projects (e.g. as a result of poorly executed resettlement plans through diversion of water supplies, or as a result of noise, environmental degradation or pollution) or from the way the company treats its workforce (e.g. wages, working conditions and housing arrangements for migrant workers). Increasingly, companies are also expected to examine and mitigate adverse impacts arising in their supply chains and through business

relationships. For oil and mining companies, this involves giving careful consideration to the companies and governments they do business with. It means structuring relationships and project agreements such that long-term investments can carry on, into the future, in a “rights respecting” way. It will also mean scrutinising contractors, especially security providers, to reduce the risk of being associated, even indirectly, with human rights abuses.

### Embedding good practice

Although all three pillars of the UNGPs are relevant to business enterprises, the pillar businesses will be focusing on most closely is, of course, the second pillar: the “corporate responsibility to respect”. This

second pillar reflects a consensus that it is time for corporate and civil society actors to start moving from a culture of “naming and shaming” to “knowing and showing”. In other words, companies must not only demonstrate a good understanding of the human rights impacts of their business activities and relationships, they must also take steps to address these impacts and be prepared to communicate their performance on human rights issues to wider audiences.

Business leaders at the 2013 UN Forum were keen to share their progress in implementing the “second pillar” over the past two years. For many, this has meant developing new human rights policies, conducting human rights impact

assessments, developing reporting and performance-tracking systems, and using the results to identify new training and capacity-building priorities. The need for a “cross-functional” approach to effectively embed human rights policies and commitments into organisational processes was a common thread.

### Involving stakeholders

Stakeholder engagement was a particular focus of the business-led discussions. The UNGPs place particular emphasis on the importance of engaging with affected stakeholders when it comes to developing policy commitments, carrying out due diligence, tracking the effectiveness of corporate responses and designing and implementing effective grievance mechanisms. Many practical examples of engagement with NGOs and stakeholder communities were showcased at the event, including information-gathering activities, innovative training programmes and collaborative impact monitoring initiatives. As Vanessa Zimmerman of Rio Tinto told the main Forum: *“It was recognised that civil society [organisations] often do support companies to ‘know and show’ that they respect human rights, including when relationships start off in a more adversarial manner”*. Some companies reported that bringing company executives into direct contact with representatives of affected groups would often prove the impetus for “tangible and rapid” change.

### Problem areas

While the UNGPs have provided greater clarity for companies with respect to social

expectations – not to mention a useful framework for action – there are still difficult areas. Key among these, and of particular concern to companies working in the extractives sector, are the problems that arise when the roles and responsibilities of companies and government become blurred. Companies working in conflict zones or areas of weak governance have plenty of experience of this, and of what the fallout can be. In these situations, it is not uncommon for companies to take on additional responsibilities for infrastructure, security, housing provision and other services, such as healthcare and education. While these decisions and investments may have positive human rights outcomes for local people, they also alter the nature and scope of the company’s human rights risks and can give rise to daily dilemmas.

Against this background, it was not surprising to hear a number of business leaders calling for a greater emphasis on the state’s “duty to protect” (i.e. the “first pillar”), arguing that increased efforts to deal with corruption and to promote the rule of law were likely to have the most positive and long-lasting effects on human rights problems in the long run.

The other key area of difficulty for companies is around the concept of “leverage”. The UNGPs urge companies to use their “leverage” in business relationships to address the human rights impacts that they might not cause directly but which are nevertheless associated with their business activities (e.g. through the supply chain). There is still some confusion about what “leverage” means in practice, with some company representatives expressing

the view that the amount of “leverage” that companies have in reality is often overestimated. Others said that, for very complex organisations, prioritising the relationships and supply chains to focus on can be a real challenge. Nevertheless, there is broad agreement about the value of participation in multi-stakeholder initiatives to raise standards and increase corporate leverage in relation to human rights issues.

### Risks or rights?

Most, if not all, companies will already have policies that cover human rights issues; policies on employment, non-discrimination, health and safety, environmental issues, and legal compliance are all potentially relevant. However, for many companies the UNGPs have not only provided a basis for more cross-functional discussion and problem-solving, they have also helped to provide fresh perspectives on corporate risk. There is growing appreciation of the different ways in which a “rights-centred” (as well as the more traditional “risks-centred”) approach can help to make corporate risk management strategies more holistic, coherent, forward-looking and robust. *“One example would be that of land access for large projects and resettlement,”* says Ed O’Keefe of human rights consulting firm Synergy. *“Most companies will ensure that they are legally compliant, but the legal requirements for compensation are rarely adequate to restore livelihoods or reflect the true replacement costs of crops and so on. So companies can be legally compliant, but if they are controlling access to land on a large scale, and affecting vulnerable groups, this could lead to accusations of involvement in serious human rights abuses.”*

## THE UN GUIDING PRINCIPLES: “PROTECT, RESPECT AND REMEDY”

The UN Guiding Principles (UNGPs) on Business and Human Rights were adopted by the UN Human Rights Council in June 2011. This set of principles remains the only global standard relating to preventing and addressing human rights impacts arising in a business context and has been widely endorsed and referenced in other contexts and international instruments, including the OECD Guidelines for Multinational Enterprises.

The UNGPs rest on a “three pillar” framework:

#### Pillar I:

**The State Duty to Protect** against human rights abuses by third parties, including business enterprises, through appropriate policies, legislation and adjudication.

#### Pillar II:

**The Corporate Responsibility to Respect** human rights, which means that companies should act with due diligence to avoid infringing the human rights of others and take steps to address adverse human rights impacts arising both directly and indirectly from their business activities.

#### Pillar III:

**Access to Remedy**, which addresses the need for victims of human rights impacts arising from business activities to have access to an effective remedy for the harm they have suffered.



## Know and show

Much of the content of the “second pillar” of the UNGPs is still, legally speaking, non-binding. To a large extent, these provisions reflect “societal expectations” rather than legal requirements. However, this is not likely to remain the case for long. Key concepts in the UNGPs – due diligence, performance tracking and human rights reporting – are gradually finding their way into domestic initiatives on procurement and export finance, as well as company law reforms. *“People now want to know how the companies they invest in, buy from, and work for, impact other human beings,”* says Anna Triponel of independent business and human rights think tank Shift. *“These demands, combined with tragic events such as Rana Plaza, are spurring a wave of regulatory and stock exchange developments around the world. Companies, wherever they are incorporated and wherever they operate, are increasingly expected to be more transparent, and share how they know that they respect human rights – not on paper, but in practice.”* In the UK, listed companies are now explicitly required to report on human rights issues to the extent that this is necessary for an understanding by shareholders of the company’s “future development, performance and position”. As mandatory narrative reporting is comparatively new – and human rights reporting even newer – most companies will be on a steep learning curve when it comes to deciding what, how, and how much to disclose on human rights risks and risk management. At what level of seriousness does a risk or impact become one which must be reported under mandatory disclosure requirements? And, without a

crystal ball, is it possible to distinguish those risks that are likely to have an impact on shareholder value from those that are not? There is a clear need for further guidance for companies. The Financial Reporting Council is presently preparing generic guidance on the various components of the “strategic report”. In addition, it is expected that sector-specific approaches will emerge, not just in relation to the “showing” but also to help companies do a thorough job of “knowing”.

## Delving deeper

Currently, the oil and gas industry is one of the better served when it comes to tools and guidance relating to human rights due diligence and reporting. The European Union has recently published comprehensive guidance for the upstream sector, developed jointly by the Institute for Human Rights and Business and Shift. Last year, IPIECA (International Petroleum Industry Environmental Conservation Association, the global oil and gas industry association for environmental and social issues) published its own guide on integrating human rights into environmental, social and health impact assessments. The Global Reporting Initiative sector supplements for the oil and gas sector and the mining and metals sector have also become important reference points. These include example key performance indicators, as well as additional guidance about structuring sustainability disclosures and the complex issue of materiality. Finally, in view of recent regulatory developments, the launch last year of the Reporting and Assurance Frameworks Initiative is timely.

The aim of this initiative is to clarify what high-quality human rights reporting, aligned to the requirements of the UNGPs, looks like in practice.

## A new legal and moral landscape

It is important to remember that the UNGPs are not a solution in themselves but a framework for getting there. While many new corporate initiatives are already having positive results, it will take time for a lot of the groundwork that is presently underway in many organisations to translate into real improvements on the ground. There is also, sadly, plenty of poor practice still out there. But it is clear that the UNGPs have transformed the ethical landscape in which conversations about corporate human rights responsibilities are taking place and are now beginning to have an impact on the legal landscape too.

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### Resources

- European Commission, *Oil and Gas Sector Guide on Implementing the UN Guiding Principles on Business and Human Rights*.  
[http://ec.europa.eu/enterprise/policies/sustainable-business/files/csr-sme/csr-oag-hr-business\\_en.pdf](http://ec.europa.eu/enterprise/policies/sustainable-business/files/csr-sme/csr-oag-hr-business_en.pdf)
- IPIECA, *Integrating human rights into environmental, social and health impact assessments*.  
<http://www.ipieca.org/news/20131206/integrating-human-rights-environmental-social-and-health-impact-assessments>
- Global Reporting Initiative  
<http://www.globalreporting.org>
- Reporting and Assurance Frameworks Initiative  
<http://www.business-humanrights.org/Documents/RAFI>

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## MINING IN AFRICA:

# Trends in regulatory reform

by Martin Kudnig and Tim Kennedy

Recent reforms of mining laws in African nations have led to a movement away from regimes regarded by many as “investor friendly”, with states seeking to assert greater control and generate increased revenues from their resources. However, the importance of a stable regulatory framework in attracting foreign investment has also been recognised. As states attempt to balance these competing goals, trends are beginning to emerge which might offer comfort to investors.

### Mining law reform

Africa hosts some of the world’s largest reserves of minerals including gold, uranium, bauxite, iron ore, diamonds and platinum. As resource prices increased, considerable wealth was created from exploitation of those minerals. However, there is a general perception that African nations have not recovered an adequate share of mining revenues due to various factors including

inefficient regulatory regimes and the superior experience and negotiating power of international mining companies. As a result, recent years have seen states attempt to reverse this position through a combination of regulatory reform and renegotiation of existing investment agreements with foreign private counterparties.

The difficulty for many African states is striking a balance between encouraging

foreign investment in the mining industry (primarily by providing a stable investment regime) and ensuring that more of the benefits of mining flow to the country in question. Striking such a balance can be even more difficult in the current climate of weakening commodity prices.

Regulatory reform is the primary means by which states have sought to increase control over resources and obtain a greater share of mining revenues. The approaches adopted by individual countries have varied, however reforms are typically aimed at (1) increasing state participation in mining operations; (2) increasing taxes and royalties; and (3) imposing local content obligations, including requirements to procure goods and services from local sources and to employ and provide training for local employees. Notable examples of such reforms include:

### State participation

Guinea has recently implemented laws giving the state the right to 15 per cent free equity participation in mining

companies with the option to acquire additional participation of up to 35 per cent. Similarly, Tanzania has adopted a mining law which authorises the state to negotiate a free equity participation in mining companies for projects requiring investment of at least US\$100m. Kenya has also introduced regulations requiring local equity participation of at least 35 per cent in companies holding mining rights.

#### Royalties

Zambia, Africa's biggest copper producer, recently doubled royalties on base metals from 3 per cent to 6 per cent and increased precious metals royalties from 5 per cent to 6 per cent. Similarly, the Democratic Republic of the Congo (DRC) has proposed an increase in royalty rates from 2 per cent to 6 per cent on non-ferrous metals and from 2.5 per cent to 6 per cent on precious metals. Burkina Faso has adopted a different approach, indexing its royalty rates on gold production with gold prices.

#### Local content

Angola and Guinea have adopted new mining laws requiring companies to employ and train citizens and procure goods and services locally. Mali requires that its minerals are processed locally, and the DRC has proposed a ban on the export of copper and cobalt concentrates to encourage domestic processing.

Other countries that have reviewed or reformed mining law regimes include Liberia, Gabon and Zimbabwe.

In addition to regulatory reform, some jurisdictions have sought to renegotiate existing investment agreements with foreign counterparties. Guinea and Ghana are two examples of governments which have established committees to review existing agreements.

### Managing risk – stabilisation clauses

Mining projects often involve long-term agreements and high levels of investment, and changes in law are a significant risk for investors. The regulatory reform trends outlined above have heightened investor concerns.

Traditionally, stabilisation clauses in investment agreements have been used as a means of “fixing” the life of mine cost and otherwise addressing the risk of a change in law having an adverse effect on the commerciality of a mining project. Such clauses can take on a variety of forms, but typical examples are:

(1) **freezing clauses**, which provide that laws in place at the time the agreement is executed will apply for the life of the agreement (although these have become less common); and

(2) **balancing clauses**, which provide for the renegotiation of the economic terms of an investment agreement in the event of a change in law, to compensate for any loss suffered by the mining company due to such a change.

Stabilisation clauses are an important means of protecting investors against changes in law, but should be used with care. A key issue to consider when negotiating a stabilisation clause is whether it will be enforceable in the relevant jurisdiction. Certain states have the ability to claim immunity from the judgments of foreign courts and tribunals by invoking the doctrine of sovereign immunity. Whether a state can invoke sovereign immunity depends on its laws, and investors should carefully consider the state's laws ahead of entering into an investment agreement to determine whether sovereign immunity can be invoked. If it can, and where the laws provide that sovereign immunity can be waived, investors should seek to include a provision under which the state waives sovereign immunity, submits to the laws/rules of an agreed jurisdiction/ arbitral body, and consents to relevant enforcement measures.

In order to obtain the protections provided by international law, the governing law provision should state that international law applies to the investment agreement.

### The Zambian example

Even where sovereign immunity does not apply, there is a risk that a state will attempt to resist the enforceability of stabilisation clauses. An example of this is Zambia, which in recent years replaced its mining law regime.

Zambia's previous mining laws had authorised the Zambian Government to enter into agreements with investors which included freezing and balancing clauses. As well as increasing royalties and taxes relating to mining projects, the new mining laws controversially provided that existing investment agreements were no longer binding on the Government. Accordingly, a number of investors who had entered into agreements with the Government, which included stabilisation



clauses under the previous regime, became subject to the increased taxes and royalties. In addition, it is understood that the Zambian Government did not compensate those affected, which may arguably, among other things, be in breach of its own constitutional requirements. As a result, affected counterparties have resorted to international arbitration against the Zambian Government to seek compensation (the outcome of which is still being determined).

### A more limited future

While the purported retrospective application of Zambia's reforms is an exceptional example, it is consistent with a recent trend of regulatory reform aimed at limiting the scope of stabilisation clauses. Guinea, Burkina Faso and the DRC have all made or proposed legislative amendments seeking to limit the applicability of stabilisation clauses (for example, permitting them to apply only to certain specified taxes) or reduce the period of time over which stabilisation clauses will apply. Accordingly, it is possible that stabilisation clauses will become a less effective tool for the protection of investor interests under future investment agreements.



## Towards legal stability

The reforms and trends described above have given mining companies seeking to invest in Africa cause for concern. However, there has been a recognition among African nations that a stable regulatory framework is important if the region wishes to remain attractive to foreign investment.

Regional harmonisation of mining regulatory regimes has in recent times gained prominence as a potential way of establishing a framework which benefits local communities while remaining attractive to foreign investment. For example, in 2009, the Economic Community of West African States (ECOWAS) agreed “The ECOWAS Directive on the Harmonisation of Guiding Principles and Policies in the Mining Sector”.<sup>1</sup> The Directive contains guiding principles for member states as to what national mining laws should address, providing (among other things) that member states (1) can enter into stabilisation agreements subject to ratification by parliament; (2) will review, update and harmonise fiscal (i.e. taxation) regimes every three years; and (3) will mutually agree the terms on which states

can participate in mining operations.

While little information relating to implementation of the Directive is available at present, and it is considered unlikely that the goals of the Directive will be achieved by the proposed July 2014 deadline, there is some evidence that member states are seeking to incorporate its principles into local laws. For example, the head of Sierra Leone’s National Minerals Agency last year stated that the country had been holding discussions with Guinea in relation to the harmonisation of mining tariffs across the West African region.

Similar statements are being made elsewhere on the continent. One of the aims of the East African Community (EAC),<sup>2</sup> as set out in the 1999 EAC Treaty, is to take concerted measures to foster co-operation in the joint and efficient management and sustainable utilisation of natural resources within EAC. The Chairperson of the East

<sup>2</sup> EAC is a group of five East African member states established (in its current form) following the signing of the EAC Treaty on 30 November 1999 and is made up of Burundi, Kenya, Rwanda, Uganda and Tanzania.

African Legislative Assembly (EAC’s legislative organ), who is also the Ugandan Minister of State for EAC Affairs, last year stated that the EAC partner states had decided to harmonise their mineral policies and laws.

As bodies, such as ECOWAS and EAC, have recognised, well-developed and harmonised mining laws and policies across African regions could increase the mining revenues available to states and promote the efficient use of such revenues within local economies, while at the same time encouraging foreign investment. Investors would have greater comfort that individual regimes will not be subject to future upheaval, and standardised laws could ease the often lengthy and complex negotiation process for investment agreements.

## Responding to investor concerns

Further positive signs can be found in an increased willingness of states to respond to investor concerns relating to regulatory reform. In the DRC, the Government recently lowered its proposed free equity participation in mining companies from 35 per cent to 15 per cent following an outcry from investors. In Zimbabwe, after deterring investors by increasing gold royalties (from 4.5 per cent to 7 per cent) and platinum royalties (from 5 per cent to 10 per cent) in early 2012, the Government announced late last year that it plans to reduce royalties. Following criticism of its 2011 Mining Code, Guinea introduced a 2013 amendment containing a number of provisions aimed at addressing investor concerns – for example, clarifying the taxation and royalty regime.

## Conclusion

In an uncertain regulatory environment, investors might take some comfort from attempts within Africa to stabilise regulatory frameworks across regions, as well as an increased willingness of states to address investor concerns. While true harmonisation of laws across African regions may be an unrealistic goal, and the extent to which African states are willing to amend recently implemented reforms remains to be seen, we expect that both issues will become more prominent as states seek to address investor concerns resulting from the recent reforms.

<sup>1</sup> ECOWAS is a group of 15 West African member states founded by the signing of the Treaty of Lagos on 28 May 1975 and is made up of Benin, Burkina Faso, Cape Verde, Ivory Coast, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo.



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## RENEWING FRENCH HYDROELECTRIC CONCESSIONS:

# Much ado about nothing

by Michel Lequien, Jacques Dabreteau and Olivia Le Baube

In an article published in Issue 11 (March 2013), we discussed certain issues raised by the long-awaited tendering of hydroelectric concessions in France and described the reasons behind the significant delay in the opening of the French hydroelectric concessions market to new operators and investors. We have been monitoring and advising on this issue since the beginning of 2009 and, as at March 2013, we were still hopeful that the first tenders would be launched by the end of 2013.

This did not happen. On the contrary, and notwithstanding heavy criticism from the *Cour des Comptes*<sup>1</sup>, the Government has recently outlined an alternative strategy that casts further doubt on the willingness of French authorities to actually open the French hydroelectricity market to new players in the foreseeable future. In this article we consider the current state of play.

### Warning of the *Cour des Comptes*

Following the end of the “energy transition debate” in May 2013 – that is, a public consultation on France’s climate and energy

strategy for the coming decades – the energy industry was expecting that a framework law on the “energy transition” (*projet de loi de programmation pour la transition énergétique*) would be issued in the course of autumn 2013 and that it would be rapidly followed by the first calls for tenders for the renewal of hydroelectric concessions.

This has not been the case. On 21 June 2013, the *Premier Président* of the *Cour des Comptes* issued a form of injunction<sup>2</sup> to the Minister of Economy and Finance, the Minister of Ecology, Sustainable

Development and Energy (*Ministre de l’écologie, du développement durable et de l’énergie*) and to the Secretary of State for Finance and Budget (*Ministre délégué auprès du ministère de l’économie et des finances, chargé du budget*) that heavily criticised the delay in launching the bidding process for the renewal of hydroelectric concessions.

The injunction pointed out that the systematic postponement of the renewal of the concessions, and the resulting delay in restructuring the French hydroelectric industry, is causing a significant fiscal loss for the State, owing to the inability by the State to levy the *redevance proportionnelle aux recettes résultant des ventes d’électricité*

<sup>1</sup> The French equivalent of the European Court of Auditors or the British National Audit Office.

<sup>2</sup> *Référé* of the *Premier Président* of the *Cour des Comptes* to the Ministers based on article R. 143-1 of the French Financial Courts Code (*Code des juridictions financières*).

(a tax based on the income generated by the sale of the electricity produced by a hydroelectric plant) on existing concessions<sup>3</sup>. It also expressed concern that the lack of strategy and consistency on the part of the Government would discourage candidates interested in participating in the process.

This prediction of the *Cour des Comptes* rapidly proved correct, with Swedish power company Vattenfall announcing, in July 2013, the dissolution of the consortium that it had formed with major electricity consumers, such as rail services operator SNCF and industrial leaders Rhodia and ArcelorMittal, and the closure of its French office. Vattenfall, which had invested substantial resources over several years in developing its understanding of, and position on, the French energy market, has invoked the political uncertainties surrounding the renewal of the hydroelectric concessions to explain its withdrawal.

### How to combine concessions of different durations?

On 27 August 2013, the Government replied to the injunction of the *Cour des Comptes*, alleging that the main reason for the delays in the renewal of the concessions was the extreme complexity arising from the need to combine concessions in the same valley that are currently operated as distinct concessions, prior to tendering them.

The former Government had announced in 2009 its intention to combine certain hydroelectric stations into “*cascades*” (or “*chaines d’aménagement*”) in order to improve the efficiency of the operation of concessions located in the same valley. This has proved to be a complex exercise due to the fact that in most cases the concessions intended to form a *cascade* in a given valley do not have the same term and, therefore, do not expire at the same time.

Thus, the combining of concessions into one single concession per valley (or *cascade*) requires the termination of certain concessions forming the *cascade* prior to their original term in order to align the term of all of the concessions of the same *cascade*. However, the early termination of concessions requires that the outgoing concessionaire be duly compensated.

The administration has anticipated the payment of significant sums of compensation in connection with the early termination of concessions required for the establishment of *cascades*. It was intended



that such compensation would be funded by the new concessionaires through the making of a down payment (*droit d’entrée*) for the acquisition of the new concessions.

In its response of 27 August 2013 to the *Cour des Comptes*, the Government explained that it has reconsidered its position on the basis that if such compensation was to be paid, the down payments in certain valleys would need to be so high – in some cases estimated at several hundreds of millions of euros – that they would be likely to constitute a barrier to entry that would adversely affect competition and, *de facto*, reduce the proceeds of the *redevance proportionnelle* generated by the concessions. The Government has, therefore, attempted to find alternative methods to regroup hydroelectric concessions.

These methods have raised new questions and created new complexities. However, while the restructuring of *cascades* has certainly led to complex technical, environmental and financial issues and difficulties, it seems clear that the real root of the delays experienced by the retendering of French hydroelectric concessions is the lack of a true political commitment by successive Governments since 2009 to open the French hydroelectricity market to new operators.

### Public tenders or public-owned companies?

The Government is now contemplating the possibility of creating dedicated public-private companies (*sociétés*

*d’économie mixte*, SEM) to which the concessions of the main hydroelectric *cascades* would be awarded directly, without tender. Under the new scheme, private operators would be entitled to hold a portion of the share capital of the SEM alongside the State and/or public sector entities.

There is strong opposition from trade unions, local political authorities, members of Parliament and others to the opening of the hydroelectric market to new French and international operators. Therefore, this solution would provide an alternative to the Government allowing the State to partially open the hydroelectricity market while maintaining control over the industry, which it deems “strategic”.

The “SEM solution” is still at a conceptual stage, raising several complex legal and economic issues, and cannot be implemented without regulatory changes. This means that it is not a simple alternative to the “direct” retendering of the concessions.

In particular, the procedure, pursuant to which the private partner in the SEM would be selected, remains to be clarified in the light of both European law and French law (see the “*Legal issues at stake*” box on page 18).

In any event, in a context where the “SEM solution” has been designed to maintain some form of public control over the hydroelectric industry (in addition to the monitoring rights already granted to it under the terms of the concession contracts), the right balance will need to be struck between public control over the concessions and the private operators’

3 Article L. 523-2 of the French Energy Code (*Code de l’énergie*) introduced by the law No 2013-619 dated 16 July 2013. The tax applies only to new and renewed concessions.

## Legal issues at stake

- Under European law, the “SEM solution” is based on the position of the European Commission on Institutional public-private partnerships (IPPP)<sup>6</sup> and the subsequent *Acoset Spa* decision of the European Court of Justice<sup>7</sup> (ECJ), pursuant to which a public service may be directly awarded to a public-private company dedicated to the performance of such service, provided that the private partner is selected through a tender process in accordance with the principles of free competition, transparency and equality of treatment set out in the Treaty.
- As a result, the private partner of the SEM partnership – who would be in practice the actual operator of the concession – would have to be selected through a European tender process, taking into account not only its professional and financial standing but also its technical ability to operate a hydroelectric concession.
- We note, however, that the decision of the ECJ discussed above was rendered in a context in which the EU directives relating to public procurement contracts were not applicable. It seems likely<sup>8</sup> that the rules provided in the EU directive relating to the award of concession contracts<sup>9</sup> would be applicable to the selection of the private partner of the SEM together with the award of hydroelectric concessions to said SEM, in accordance with the recommendations of the European Commission on IPPP<sup>10</sup>.
- Under French law, according to the French Administrative Supreme Court (*Conseil d'Etat*)<sup>11</sup>, the IPPP, as defined by the European Commission, does not comply with French public procurement rules, nor with the regulations currently applicable to SEM, so that the implementation of the IPPP scheme into French law would require substantial amendments to existing legislation. The feasibility of the “SEM solution” for hydroelectric concessions would, therefore, be subject in practice to such amendments being first adopted.
- A proposed law on “local” SEMs established by local authorities and dedicated to a single project (*proposition de loi tendant à créer des sociétés d'économie mixte à opération unique*) is currently under discussion before the French Parliament. Its terms may inspire another bill of law that would be required to allow the French State to establish “national” SEM for the purpose of operating hydroelectric concessions (presumably the future law on the “energy transition”).

right to operate such concessions if the Government wishes to attract new entrants to the French hydroelectricity market.

Finally, we note that the “SEM solution” would not relieve the Government from the obligation to restructure and combine existing concessions and would further imply that the State (and/or public entities) would be obliged – through their participation in the SEMs – to bear at a minimum a portion of the burden of the early termination compensation owed to outgoing concessionaires.

### Recent announcements – next steps

Since the Government announced the “SEM solution” in February 2014, a new Minister has been appointed in charge of Ecology, Sustainable Development and Energy.

Immediately upon her appointment on 2 April 2014, Ségolène Royal declared in a press interview that there remained numerous sensitive issues to be resolved before the adoption of the long-awaited law on the “energy transition” so that a draft of the new law may not be expected to be submitted to Parliament before June 2014.

The Minister of Ecology, Sustainable Development and Energy confirmed in an official press release dated 29 April 2014

that the Government is favouring the “SEM solution”, with the public sector retaining a majority of the shares in the new concession operators. The Minister considers that public control is required, as merely tendering the hydroelectric concessions to private operators entails the “*risk of adversely affecting the general interest in terms of the conservation of water resources, the ecological balance of the valleys and the electricity distribution conditions*”<sup>4</sup>.

*Compagnie Nationale du Rhône* (CNR), which operates several hydropower plants representing around 11 per cent of the French hydroelectric capacity<sup>5</sup> and is majority-owned by public sector institution CDC (*Caisse des dépôts et consignations*) and several local authorities (50.03 per cent), with GDF Suez holding a significant minority (49.97 per cent), provides a model for the “SEM solution”.

According to press releases, this solution would apply only to major concessions, i.e. those above a threshold to be determined

(between 600 MW and 1,000 MW). Ségolène Royal has also confirmed that the detailed terms and conditions of the SEM scheme shall be defined in the future law on the “energy transition”, a bill of which law will be submitted to Parliament before the summer. Their conformity with EU legislation will also need to be confirmed with the European Commission. This means in practice that the restructuring of the hydroelectric concession will be further delayed and the first tenders are unlikely to be issued before the second half of 2015.

4 La mise en concurrence pure et simple des concessions hydroélectriques présente des “risques pour l'intérêt général de la gestion de la ressource en eau, de l'équilibre écologique des vallées et des conditions de distribution de l'électricité”.

5 CNR owns around 2.9 GW out of a total hydroelectric capacity of 25 GW in France. CNR produces approximately 20 per cent of the French hydroelectric production.

6 Interpretative communication on the application of Community law on Public Procurement and Concessions to institutionalised PPP (IPPP) 2008/C 91/02, Official Journal C 91 of 12 April 2008.

7 EU CJ 15 October 2009, *Acoset Spa*, case C-196/08.

8 The directive 2014/23/EU sets out that it shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union (the directive was published in the OJEU dated 28 March 2014), and that Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with the directive by 18 April 2016.

9 Directive 2014/23/EU of the European Parliament and of the Council of 26 February 2014 on the award of concession contracts.

10 See sections 2.1, 2.3-1, 2.3-3 and 2.3.4 of the interpretative communication on the application of Community law on Public Procurement and Concessions to institutionalised PPP (IPPP) 2008/C 91/02, Official Journal C 91 of 12 April 2008.

11 *CE, Section de l'administration, Opinion (avis) No 383264* of 1 December 2009.



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## UK ENERGY MARKET:

# Competition inquiry on the front burner?

by Neil Cuninghame and Emily Clark

Following a competition assessment requested by the UK Government in October 2013 and completed jointly with the Office of Fair Trading (OFT)<sup>1</sup> and the (now fully established) Competition and Markets Authority (CMA), the Office of Gas and Electricity Markets (Ofgem) published for consultation on 27 March 2014 a proposal to make a market investigation reference (MIR) to the CMA in respect of the supply and acquisition of energy in Great Britain (GB). In this article, we consider the political and regulatory context for the investigation proposal, as well as its implications.

### The political drivers

MIRs are a tool used where it is thought that competition in a market may not be working effectively and to determine whether there are structural or other changes which could be made to improve the position if that is the case. The proposal comes against the backdrop of steadily rising fuel bills (nearly tripling over ten years) and relatively high market concentration (the major energy suppliers, known as the “big six”, account for around 95 per cent of the UK’s domestic gas and electricity retail supply market), creating a high degree of public suspicion and mistrust, and pushing energy up near the

top of the political agenda. The political “toxicity” (as some commentators have put it) of energy prices is unsurprising given the impact of energy bills on household budgets, raising issues of affordability amid accusations of profiteering by the large energy companies.

The Labour Party leader, Ed Miliband, stoked the political fire in September last year by promising, among other things, to freeze energy prices for 20 months if Labour wins the general election in May 2015. This was seen by many as “good politics, bad policy” given the opinion poll evidence suggesting voter support, but the many strong objections to the proposal, including the risk of undermining private investment incentives. Despite the various objections, the benefits of such a bold statement were

perhaps not lost on market players, with SSE announcing in March 2014 a self-imposed freeze on its customer bills until 2016. The Coalition Government responded to the Miliband promise by transferring the funding for certain green levies (such as the warm homes discount to insulate vulnerable people’s homes) from energy bills to general taxation, and by announcing the competition assessment which preceded Ofgem’s proposed MIR.

Backing for a market investigation has come not only from new entrants trying to grow their market share and certain politicians (even Energy Secretary of State, Ed Davey, wrote to Ofgem and the CMA in February 2014 urging them to consider very carefully whether a MIR was appropriate, in particular in light of what he claimed

<sup>1</sup> The OFT was merged into the newly established CMA on 1 April 2014.

were high margins and high prices in the gas sector), but also from some of the large energy supply companies themselves (for example, E.ON and EDF Energy). The hope of these energy companies is that a dispassionate review of the facts by an independent competition authority will allow customer trust (and investor confidence) to be restored. The Coalition may also be hoping to neutralise what has become a very thorny political issue in advance of the general election next year.

It is for Ofgem to exercise its discretion as to whether to make a reference, but the CMA might be expected to welcome a case which chimes with its stated priorities. The CMA's first Annual Plan makes it clear that the new authority is focusing on promoting competition in regulated industries, and an 18-month investigation early in the CMA's existence could be seen as attractive given the importance of the energy sector to the economy and consumers.

Ofgem's consultation on its proposal closed on 23 May and Ofgem is expected to make a final decision in June. David Currie, CMA Chairman, said publicly in April that a reference is "very likely".

### The MIR tool: Ofgem passes the baton to CMA

If a market investigation commences in the summer (which seems likely), the CMA will investigate whether there are features of the GB energy market which prevent, restrict or distort competition. If so, it must then identify a means of remedying, preventing or mitigating those effects, taking account of any benefits which those market features may deliver to customers. The regime exists to address issues in markets which are found to be insufficiently competitive, but where the problems do not arise from an infringement of general competition law (cartels or other anti-competitive agreements between firms, or the abuse of a dominant position).

When the market investigation regime was established in 2002, it was anticipated that there would be about four market investigation references a year (three from the OFT and one from a sector regulator). In fact, there have been considerably fewer references, and only two in total from sector regulators: namely, the reference of the rolling stock leasing market by the Office of the Rail Regulator and a reference relating to movies on pay TV by the Office of Communications. Ofgem has made no MIRs thus far.

In 2010, the National Audit Office identified that sector regulators could have a different perspective on competition

issues within their sector "and that this could colour their view of the potential benefits of referring their market to the Competition Commission"<sup>2</sup> Disincentives to refer were also identified due to a perceived loss of control over the outcome and any remedies imposed, the length of the process, and the uncertainty created in the industry. It has also been suggested that referral of a market that a sector regulator is charged with regulating could be perceived as an admission of defeat. These concerns led to amendments to the regime under which sector regulators enjoy concurrent competition powers, including the power to make MIRs (implemented as part of the Enterprise and Regulatory Reform Act 2013), and a new power for the Government to remove concurrent functions (widely seen as a "use it or lose it" provision).

### Ofgem's regulatory intervention in the market

Ofgem's proposed reference comes after prolonged attempts by Ofgem to address aspects of the GB energy markets which it has previously identified are not working well, using its sector-specific regulatory powers rather than its competition powers.

Thus, in 2009, following its 2008 energy supply probe, Ofgem introduced a suite of licence condition changes which were intended, among other things, to promote more effective consumer engagement and help consumers make better informed choices. These measures included obligations on energy suppliers to have cost-reflective tariffs and prohibited "undue discrimination".

Then, in November 2010, Ofgem commenced a review of the effectiveness of the retail energy market amid concerns regarding increasing margins. This so-called Retail Market Review (RMR) was a lengthy process, that ultimately resulted in further remedies which aim to enable consumers to get a better deal from energy companies. These remedies were finalised in 2013 and include measures to reduce the number and complexity of tariffs (suppliers are essentially limited to four core tariffs per fuel and payment type) and to oblige suppliers to inform customers of the cheapest tariff available to them. The measures were introduced by way of a phased implementation, but most are now in force. The Government has also taken powers under the Energy Act 2013, allowing the Secretary of State for Energy and Climate Change to make changes to supply licence conditions relating to the tariffs

offered to domestic energy consumers. It is intended that this power may be exercised if the interventions taken forward by Ofgem do not achieve their goal.

As the culmination of a related lengthy review of wholesale market liquidity in the electricity market, in January 2014, Ofgem also finalised reforms aimed at increasing liquidity, principally in order to assist independent suppliers to gain access to the wholesale products they require. To a large extent, the concerns about insufficient liquidity in the wholesale electricity market arose out of the high degree of vertical integration between electricity generation and downstream supply, with the big six accounting for around 70 per cent of generation capacity. The big six are now subject to requirements to make supply available to smaller suppliers,<sup>3</sup> and to separate "market making" obligations.

In February 2014, Ofgem announced various additional measures to increase the transparency of energy company profits (including increased auditor scrutiny of segmental statements, a review of transfer pricing policies and a requirement to provide greater cost breakdowns). To some extent at least, this is driven by accusations that the vertically integrated energy companies are able to report low/negative profits in their supply divisions by "hiding" profits in their generating businesses.

Ofgem has said that it remains confident that its various measures will improve competition in the market, but has nevertheless now provisionally decided to make a MIR due to the high level of customer mistrust and what Ofgem describes as the "worsening context". In particular, Ofgem is concerned that the RMR reforms may not deliver the level of customer engagement and the necessary "transformational effect" at the pace required. Ofgem also refers to the possibility that its reform package may not have gone far enough to unlock competition.

### Investigating a market in flux will present challenges

Ofgem's carefully worded defence of its efforts is unsurprising. In contrast, other parties may welcome the opportunity provided by a MIR for the CMA to investigate whether the regulatory measures imposed by Ofgem in recent years are themselves part of any competition problem which is identified. For example, critics of Ofgem's tariff simplification policy (including Stephen Littlechild, Director General of the Office of Electricity Regulation, one of Ofgem's predecessor bodies, from

<sup>2</sup> The Competition Commission, like the OFT, was merged into the CMA on 1 April 2014.

<sup>3</sup> The other two large generating groups, Drax and GDF Suez, are also subject to these obligations.

1989 to 1998) have argued that the policy could in fact reduce competitive pressure and effectively prevent innovation.

Analysing the competition implications of Ofgem's measures will be a challenge, because many of them have only recently been brought into effect (and some only take effect later this year). Ofgem has also made it clear that it intends to continue with its ongoing regulatory projects, which are aimed at improving competition and maintaining security of supply. Moreover, there are wider policy initiatives which the CMA will need to take into account; it will have a ringside seat, for example, when the first auctions of capacity take place under the Government's recently introduced Electricity Market Reform programme later this year. Higher perceived risks associated with the energy market could affect bidding in this capacity mechanism. There are also likely to be further developments towards achieving an integrated Europe-wide market.

Equally, political intervention during an inquiry cannot be ruled out. In December 2013, the Labour Party's energy spokesperson said the party would, if elected, require vertically integrated companies to operate their generation and retail supply units as separate entities. Similarly, the current Government was not deterred by a CMA investigation into the payday lending market from intervening (by way of a last minute amendment to the Financial Services (Banking Reform) Act) to require the Financial Conduct Authority (FCA) to implement a price cap by 2 January 2015. This decision was made by the Government before the CMA had got much beyond information gathering.

However, the CMA will at least have some recent experience of a shifting regulatory landscape from its work in relation to the payday lending investigation, where not only is the impending price cap expected to affect market conditions (in particular, incentives to enter the market), but a raft of regulatory measures identified by the FCA are also due to be implemented during the course of the investigation. The CMA has indicated that it will consider whether any regulatory changes are likely to "strengthen or weaken" any market features considered by it to lead to an adverse effect on competition.

### Impact on investment?

A MIR will take at least 18 months and it will, therefore, be late 2015 at the very earliest before an outcome is known. Significant investment is required in the near term to address an anticipated capacity squeeze and it appears to have been accepted that the

investigation could add further uncertainty, inhibiting decision-making. Ofgem's view is that uncertainty exists in any event and "the alternative of waiting to see the impact of our reforms would leave the prospect of reference as a risk to investment for a longer period". In other words, faced with an impact on investor confidence under either scenario, Ofgem prefers a scenario where the period of uncertainty is limited.

### The key issues likely to be investigated by the CMA

Ofgem identifies a range of persistent problems, some of which it believes have worsened in recent years, and considers that there is clear evidence that consumers are not being served well by current levels of competition. Among the issues identified are the following:

- (a) low level of consumer engagement, coupled with a low level of consumer trust, leading to weak demand side pressures. Ofgem is also concerned about falling rates of switching;
- (b) incumbency advantages allowing the exercise of market power; for example, charging higher prices to "sticky" customers while offering better deals to active customers. Ofgem's view is that its tariff simplification measures should help to address this;
- (c) increases in profits in recent years with no clear evidence of efficiency improvements, although Ofgem has not reached a conclusion on whether excess profits have been made;
- (d) possible tacit collusion with evidence of alignment in pricing announcements and asymmetry in the speed of upward adjustment of prices following cost increases as compared to downward adjustments; and
- (e) concerns as to whether the vertical integration between generation and supply is in consumers' interests. However, Ofgem is notably cautious in its conclusions, noting that it has not examined in depth the reasons for vertical integration, the claimed benefits and the implications for barriers to entry, nor the net impact on consumers overall. It is envisaged that the CMA will look closely at the balance of costs and benefits of vertical integration.

### Wide powers available to the CMA

The powers which the CMA can deploy in devising remedies for any problems it finds are extremely wide and, if used, could result in very different market structures. They range from price regulation to divestment; for example, the forced sale of three airports by BAA following a market investigation and the requirement for HCA to sell off London hospitals following the CMA's recent investigation into private healthcare.

Ofgem sees vertical integration as an issue where the CMA has the ability to make changes that Ofgem could not, namely structural reform. While speculation as to what structural reform might entail has focused on forced separation of ownership of generation and supply businesses, other less radical options might include strengthening the ring fences around the generation and supply businesses, or requirements legally to separate generation and supply businesses to improve transparency (as SSE has recently pledged to do, and some of the suppliers already do).

If the CMA does find that there are features of the regulation of energy markets that are part of the competition problem, it may have to limit itself to making recommendations to Ofgem or the Government or both.

### Conclusions

If, as predicted, Ofgem refers the GB energy market to the CMA for a full-scale investigation, the CMA will find itself centre stage in the thorny debate about how to reconcile the "trilemma" of sustainability, security of supply and affordability, and is likely to be required to consider this while the regulatory and policy ground is shifting under its feet. While attention has focused on the possibility of a radical break-up and reshaping of the industry, it will also be fascinating to see whether the CMA concludes that Ofgem's regulatory measures can be expected to have a positive impact on the evolution of competition, and whether the CMA is prepared to shine a bright light on potentially conflicting policy objectives; for example, the implications of funding new infrastructure and environmental objectives through increasing customer bills.



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**THE HEAT IS ON:**

# RHI support for CHP plant

by Antony Skinner and Justyna Bremen

The Renewable Heat Incentive (RHI), which was launched in Great Britain in November 2011, has an important role to play in supporting Combined Heat and Power (CHP) plant (also referred to as “co-generation”). As discussed in this article, currently renewable CHP plants are able to receive support for their heat output in the same way as for their electricity output, but this option is being phased out, meaning that the RHI can no longer be ignored by CHP project developers.

## What is the RHI?

The RHI is a scheme that offers support to generators of heat from renewable energy sources. The framework for the scheme is set out under the Renewable Heat Incentive Scheme Regulations 2011 (RHI Regulations 2011). The scheme is administered by the Office of Gas and Electricity Markets (Ofgem). Ofgem is responsible for processing applications for accreditation for the RHI, making payments, and monitoring compliance with the scheme. Funding for the scheme comes directly from the UK Treasury, unlike the Renewables Obligation (RO) which is funded by licensed electricity suppliers and passed through to electricity consumers.

The RHI scheme, established under the RHI Regulations 2011, applies in England, Wales and Scotland. A separate RHI scheme,

operating since 1 November 2012, applies in Northern Ireland, and is also administered by Ofgem.

Under the RHI scheme, financial support is paid for the lifetime of the installation, up to a maximum of 20 years. Payments are made by Ofgem on a quarterly basis. A payment is received for each kilowatt hour (kWh) of renewable heat generated. Receipt of payments is conditional upon the owner of the installation continuing to comply with various ongoing obligations, such as complying with metering requirements, and, of course, the continued use of a renewable fuel source.

Once an installation is accredited under the RHI, a tariff is assigned to the installation based on its technology type and size. Tariffs are adjusted annually

for inflation in line with the Retail Price Index, but otherwise, the tariff a generator qualifies for upon accreditation applies for the life of the installation regardless of subsequent changes to tariffs.

## How is support for renewable CHP projects changing?

### The Renewables Obligation/RHI

Currently, the RO regime provides the main form of support for renewable energy projects in the UK. Eligible projects are supported by receiving green certificates called Renewables Obligation Certificates (ROCs) for the electricity they generate. Under the RO regime, CHP plants have been able to receive the so-called “ROC uplift” (also referred to as the “CHP uplift”) in recognition of the fact that they also produce heat, and are therefore more efficient. This means that a CHP plant receives more ROCs than it would if it was the same technology type but did not produce heat.

CHP plants seeking accreditation between 1 April 2013 and 31 March 2015 have a one-off choice to receive either the ROC uplift for their heat or the RHI.

From 1 April 2015, new CHP plants or existing plants that add additional capacity will no longer have the choice to opt for the ROC uplift under the RO and will only be able to apply for RHI support for their heat (except in some circumstances where the RHI is not available) and support under the RO for their electricity.

One exception to the general rule is in relation to Energy from Waste (EfW) CHP projects. EfW projects without CHP are not eligible for support under the RO, meaning that there is no ROC uplift for EfW CHP projects. Therefore, EfW CHP projects can seek support either under the RO or the RHI, but not both.

### Contracts for Difference/RHI

The UK Government is currently in the process of implementing a new Contracts for Difference (CfD) regime to support low-carbon generation. CfDs will replace the RO as the main form of support for new renewable energy projects. Under the CfD regime, generators will receive a top-up above the wholesale price (the “reference price”), up to a set “strike price”. The strike price is intended to be an amount equal to that needed to make a project economically viable.

As with the new approach being taken under the RO, heat will not be supported under the CfD regime. The Government has said that the strike price for dedicated biomass CHP plants has been set on the assumption that generators will apply separately to receive the RHI for any heat produced. Therefore, a dedicated biomass CHP plant that meets all the relevant eligibility criteria will receive support for its electricity under a CfD, and for its heat under the RHI.

The position is different for EfW CHP. In line with the position being taken under the RO, an EfW CHP plant can only apply for a CfD or support under the RHI, but not both.

### The level of RHI support for CHP

A number of renewable heat technologies are currently supported under the RHI, including solid biomass, solid biomass contained in municipal waste, geothermal and biogas combustion. Some additional technologies, including deep geothermal, are currently being added to the list.

Initially there was no separate tariff for CHP installations; instead, CHP installations

were able to claim the RHI tariff applicable to the heat technology they use, provided they were not also claiming additional support for their heat under the RO (the ROC uplift), as discussed above.

However, a new tariff is being introduced in 2014 for biomass CHP plant, at the rate of 4.1p/kWh, pursuant to the Renewable Heat Incentive Scheme (Amendment) Regulations 2014 (Amendment Regulations 2014). Receipt of the new CHP RHI tariff will be conditional upon the installation being Combined Heat and Power Quality Assurance Standard (CHPQA) certified. The new CHP RHI tariff of 4.1p is available to projects commissioned after 4 December 2013 (the date of the final decision by the Department of Energy and Climate (DECC) on the new tariff) and accredited after the Amendment Regulations 2014 come into force.

CHPQA certified conversions of fossil fuel systems to biomass will be eligible for the CHP tariff from 4 December 2013 provided that the CHP conversion is commissioned after this date.

A biomass installation not seeking CHPQA will remain eligible for the corresponding biomass tariff dependent upon the capacity of the installation. The new CHP RHI tariff is not available to bioliquid CHP or EfW CHP projects.

The standard tariff for biomass installations over 1MWth capacity will receive 2.0p/kWh tariff (up from 1.0p), and this will be available to EfW CHP projects. The new 2.0p tariff will be available to projects which are accredited from 21 January 2013 (the date DECC first announced its decision to increase the tariff).

See the table below for a summary of the support available.

### Specific eligibility requirements

The eligibility requirements under the RHI scheme are quite complex. The following are some eligibility requirements that CHP project developers need to be particularly aware of:

### Delivery of heat

The installation must use liquid or steam as a medium to deliver heat.

### Heat use

The heat must be used for an “eligible purpose”, meaning that it is used:

- in a building for heating a space, heating water, or carrying out a process; or
- used otherwise than in a building, for cleaning or drying, carried out on a commercial basis.

The underlying principle is that the heat must not be wasted or generated for the sole purposes of receiving the RHI.

### Biomass boilers

A biomass boiler must be specifically designed and installed to use solid biomass as its only primary fuel source.

### Air quality requirements

Air quality requirements for biomass boilers were introduced in September 2013. These requirements include new eligibility criteria for applicants with biomass boilers, and new ongoing obligations to ensure boilers do not exceed a maximum level of particulate matter (PM) and oxides of nitrogen (NOx).

### Waste

Originally the RHI applied to the proportion of heat generated from the biomass in municipal solid waste (MSW), which has a biogenic content of 50 per cent or higher. However, the Amendment Regulations 2014 have extended this to support heat generated from commercial and industrial wastes, and amended the minimum biogenic content to 10 per cent. Support is available at the tariff rates offered for biomass according to the percentage of biogenic content. Therefore, to cite an example, if heat is generated from MSW with a biogenic content of 20

Figure 1: RHI tariffs applicable to waste and biomass CHP, as from 1 April 2014

| Technology  | Size                                | Tariff rate (subject to RPI increases)   |
|---|-------------------------------------|--|
| Solid biomass CHP with CHPQA  | All                                 | 4.1p/kWh (new tariff – available for plant commissioned on or after 4 December 2013 and accredited after Amendment Regulations 2014 come into force) |
| Small commercial biomass (including waste, and CHP which is not CHPQA)  | Less than 200 kWth                  | Tier 1: 8.6p/kWh<br>Tier 2: 2.2/kWh  |
| Medium commercial biomass (including waste, and CHP which is not CHPQA) | 200 kWth and above; less than 1MWth | Tier 1: 5.0p/kWh<br>Tier 2: 2.1/kWh  |
| Large commercial biomass (including waste, and CHP which is not CHPQA)  | 1MWth and above                     | 1.0p/kWh (increasing to 2.0p/kWh for plant accredited on or after 21 January 2013)   |



per cent, then the tariff received for each kWh of heat will be 20 per cent of 2.0p, which is equal to 0.4p/kWh.

### **Biomass sustainability**

Currently, biomass installations of 1 MWth and above are required to report quarterly to Ofgem on the sustainability of their biomass feedstock, providing information such as quantity, type and form, country of origin, and any environmental accreditation of the biomass. At present, receipt of the RHI is not tied to any minimum sustainability standards, but DECC intends to introduce sustainability requirements for the use of solid biomass and biogas for heating ahead of the possible introduction of mandatory EU sustainability criteria. The standards will apply to existing as well as new biomass installations under the RHI. The RHI sustainability standard will consist of two criteria: i) a greenhouse gas (GHG) lifecycle emissions target; and ii) land criteria. The GHG criteria are likely to be implemented from Autumn 2014, while the land-use sustainability criteria by 1 April 2015. CHP plants receiving ROCs under the RO, and therefore demonstrating compliance with the RO sustainability criteria, will not be separately required to demonstrate compliance with the RHI sustainability criteria.

### **Accreditation**

Accreditation of an installation is key, because no payments under the RHI can be received until an installation is accredited. Accreditation can take place once the installation is commissioned. Timing can be critical for the success of a project, because the date of accreditation will determine the tariff that will apply. In 2013, the Government introduced a tariff degression mechanism to control spending on the RHI. The degression mechanism gives the Government the opportunity, every three months, to decrease all or some tariffs, if take-up is high. Any tariff decreases only

apply to installations not yet accredited for the RHI (that is, they do not apply retrospectively). However, this means that projects (even those under construction) run the risk of the tariff decreasing before they are able to achieve accreditation.

Large biomass and waste CHP plants are able to apply for preliminary accreditation, once planning permission has been received. Preliminary accreditation provides assurance to developers that Ofgem will grant full accreditation providing that the relevant installation is built in line with the plans submitted, and also other conditions are met. However, preliminary accreditation does not lock in the tariff rate for projects and the tariff rate is still determined by the date of full accreditation.

To address the risk of tariff reductions faced by larger projects with longer development timescales, such as CHP plants, the Government has said that it will introduce a “tariff guarantee” for such projects. The intention is that the “tariff guarantee” will be available from April 2015 for plants due to be commissioned by 31 March 2016, and subsequently from spring 2016 for plants due to be commissioned by 31 March 2020.

### **Risks**

Developers of CHP projects seeking support under the RHI need to be aware of the following issues that may pose a risk to a project:

#### **Tariff degression**

As mentioned above, tariff degression poses

a risk during the development of the project. It is important for developers to monitor the monthly deployment information published by DECC, and the quarterly degression announcements. Possible reductions need to be factored into the financial model, and the risk appropriately allocated or analysed. Looking forward, the Government will conduct a full review of the RHI scheme in 2014, which may impact on projects seeking accreditation from April 2015.

#### **Accreditation**

Developers need to become familiar with the eligibility and accreditation requirements, including ongoing obligations, at an early stage to ensure that the project can receive support under the RHI.

#### **Feedstock**

For biomass feedstock, it is important to ensure that any arrangements for the supply of feedstock contemplate compliance with the new sustainability requirements, and that appropriate provisions are included in the supply agreement. For waste feedstock, fuel measurement and sampling (FMS) requirements apply, to ensure that support is only received for the biomass component of the waste, as opposed to the fossil-derived contamination of the waste.

#### **Heat offtake**

Heat offtake is a critical issue for CHP plants, because support under the RHI can only be received if the heat is actually used for a legitimate purpose. Ofgem requires applicants to provide information about heat use as part of the accreditation process, and this is monitored on an ongoing basis. How heat is used, and what proportion of it is used usefully, is an issue that is also considered as part of the criteria for a plant applying for certification under the CHPQA. It is, therefore, essential that CHP projects need to consider their heat offtake arrangements to ensure they comply with the requirements of the RHI scheme. Any heat offtake agreement entered into needs to include obligations on the offtaker to take a minimum quantity of heat each year and use the heat appropriately (rather than just vent it) and also provide remedies to the CHP plant if the obligations are breached.



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## AFRICAN OIL & GAS AND RESOURCE NATIONALISM:

# A swinging pendulum

by Nicolas Bonnefoy and Jerome Basdeo

It is an indisputable fact that Africa is a continent with rich oil and gas resources, which have the potential to greatly benefit its local economies. But, as many governments have discovered in recent years, achieving the right balance between the respective interests of the host state and international investors is a difficult task, made all the more difficult by the politicisation of oil and gas resources. In this article, we consider the issues that are of key concern under a typical oil and gas regime, for investors and host governments alike, and that need to be weighed up appropriately to ensure that the regulatory pendulum does not swing too far in either direction. A swing too far in favour of investors can result in a loss of much needed revenue, while a swing too far towards government control and interest – so-called “resource nationalism” – can present serious obstacles to international investment.

### The fiscal terms

While other issues can make or break an oil and gas regime, ultimately it is all about the money. Host governments need to secure maximum revenue from their resources, while at the same time ensuring that international oil companies (IOCs) can generate an acceptable level of return. There is no international benchmark for this figure and the state's share of revenue will largely depend on the attractiveness and abundance of the state's hydrocarbon resources. For example, in percentage terms, in Ireland and South Africa the state's take is in the 30s, while in Iraq and Algeria it rises to the 90s.

The main fiscal tools available to the

state to recover its share of revenue include the following:

- Payments based on either hydrocarbon production royalties or surface royalties. Royalties are the most common tool for states to earn income from hydrocarbon exploration. In Africa, the range of royalty rates is very wide. For example, in Algeria, royalty rates range between 5.5 and 23 per cent.
- Bonus payments, which are included by approximately 40 per cent of African states' hydrocarbon legislation. Some countries do not require any bonuses to be paid, while in others, signature bonuses can be as high as \$300m.
- Production sharing, through an

allocation of cost oil/gas and profit oil/gas between the IOC and the host state.

Most production sharing agreements (PSAs) have a cost oil limit of 50 to 70 per cent or so of production, but this can be higher. Alternatively, the regime may not provide for recovery of costs through cost oil at all, meaning that costs have to be recovered from profit oil.

- Domestic legislation may permit a state to participate in a hydrocarbon contract, either directly or indirectly, through its own national oil company (NOC). In Africa, the level of state participation varies considerably. In Angola, for example, the level of state participation



is 50 per cent, while in Cameroon that figure drops to just 5 per cent.

- Income tax may also be applicable on an IOC's share of its profit oil. For instance, IOCs are required to pay income tax on their share of profit oil at a rate of 50 per cent in Angola and 25 per cent in Mauritania.

### Control of petroleum operations

Host states will generally want to exert a level of control over oil and gas operations to ensure, among other things, that maximum economic benefit can be derived from their reserves in a timely and efficient manner. Such control generally encompasses a wide range of measures, including requirements that the IOCs have the required level of financial and technical resources to carry out petroleum operations; a requirement that work obligations are carried out and work programmes are approved; and controls over the transfer of interests to third parties. Where the state or an NOC is a party to a PSA with the IOC, the state or NOC is also likely to be a member of the operating committee, and exert a level of control over day-to-day operations.

Problems can arise where the level of control is such that it impedes the IOC's ability to drive the development forward, or where the relevant powers give the state too much discretion to arbitrarily withhold approvals.

### Management of HSE issues

Management of health and safety and environmental (HSE) issues is a key priority for host governments. This is especially so since the Deepwater Horizon incident. An effective HSE system will involve

performance-based regulation, dedicated administration of the regulation (which can include a dedicated regulator), and an effective decommissioning and restoration liabilities regime. In recent years, there has been a trend towards performance-based regulation, as opposed to prescriptive regulation, particularly among countries with an established oil and gas regime, such as Norway. The performance-based model allows IOCs more flexibility, but also benefits the host state, as it prevents IOCs from taking a passive approach to HSE issues and also allows the state to legitimately impose strict liability on companies. Nonetheless, some governments fear that letting go of prescriptive regulation will dilute their control over HSE matters.

From an IOC's point of view, clarity and transparency is critical. A lack of a clearly defined HSE regime can pose a risk to IOCs, as it presents a barrier to compliance. A further risk can be posed by the retrospective imposition of a new HSE regime.

### Local content

Local content obligations recognise the need to encourage the development of the local economy and local activities linked to petroleum operations. It has indeed been recognised as good practice for developing nations to include such obligations when establishing an oil and gas regime. States may have legislative provisions which prescribe a range of measures, including a minimum percentage of indigenous workers which need to be employed by the IOC in the host state; training requirements; and obligations to establish funds to provide local infrastructure facilities. There are many examples across Africa of investors meeting local content requirements, ranging from funding hydrocarbon-specific technical studies, to building schools, roads and hospitals. Concerns can arise where the local content obligations are too onerous relative to the commercial rewards available to the IOC, or if new obligations are imposed retrospectively. A further issue that frequently arises is the lack of readily available locally manufactured goods, local services or local personnel with the right level of skills and training, leading to delays.

Last year, Ghana passed the Petroleum Local Content and Local Participation Regulations 2013, imposing new ambitious local content requirements on IOCs. The new law comes in response to concerns that Ghana's oil and gas regime has, in the past, offered overly generous rewards for IOCs. But there is concern that the new law has gone too far in the other direction.

### The right to monetise

The right to monetise is a critical right for IOCs. It is the IOC's legitimate expectation that it will be entitled to produce a commercial discovery. It goes without saying that an IOC needs assurance that, following heavy investment in exploration and appraisal, they will have the right to profit from production. However, that right will typically be subject to various conditions – the most important one being the approval by the host government of a development plan. The key point here is that, from an IOC's perspective, the relevant conditions must not give rise to a risk that the IOC may lose its right to monetise, notwithstanding its compliance with its work obligations and other terms.

### Stability of the petroleum regime

When investing in a state, regulatory stability (or at least flexible stability) is of paramount importance for IOCs. It is common to see stabilisation clauses in oil and gas investment agreements which seek to address any risk of future law changes which would adversely affect the commerciality of a hydrocarbon project. While a stabilisation clause cannot prevent a host government from changing the legal and tax regime, it can protect the IOC from adverse consequences by providing for changes to fiscal and other terms. In recent years, there has been a move away from so-called "freezing clauses" which freeze the legal regime applying to the project as at the date of the relevant agreement towards clauses which simply seek to maintain the "economic equilibrium" of the project.

### Enforceability of the petroleum regime

If disputes arise, IOCs require assurance that they will be able to enforce any petroleum rights. Usually, international arbitration is the preferred method of resolving large-scale disputes, at least from an IOC's perspective. Provisions in hydrocarbon investment contracts will usually stipulate that the forum for resolution of international investor/state disputes will be the International Centre for Settlement of Investment Disputes (ICSID). Alternatively, provision may be made for resolution of disputes by the ICC Court of Arbitration. An important point to note is that as ICSID is a member of the World Bank Group, any investor/state dispute (a state's non-compliance) may adversely affect any funding which the state receives from the World Bank.

It is also desirable for some disputes of a more technical nature to be determined by expert determination.



## The resource nationalism dilemma

Subject to some minor exceptions, mineral and hydrocarbon resources are national resources, and national governments across the world seek to ensure that exploitation of those resources secures the maximum possible benefit to the nation. With that objective in mind, it is usual for governments to regularly re-examine the terms of their oil and gas regime, so as to respond to the changing global oil and gas landscape. For instance, in 2002, the UK Government introduced a new Supplementary Charge payable on oil and gas profits, in addition to other taxation, and with the rising oil price, in 2011 that Charge was increased from 20 per cent to 32 per cent. In developing nations, however, where oil and gas resources potentially play a much bigger role in determining the success or failure of the local economy, the stakes are higher.

In the African context, the oil and gas industry has been controversial, bringing in much needed cash, but also attracting criticism that it has not achieved as much towards the development of local economies as it should have. This has driven many governments of African nations towards resource nationalism; that is, redesigning their oil and gas regimes to give the government maximum control, discretion and fiscal returns. This has given rise to a dilemma: can resource nationalism be compatible with attracting investment from IOCs? Ultimately, host governments need to achieve a balance, taking into account a multitude of factors, including the attractiveness of the oil and gas reserves, the terms offered by other competing jurisdictions, and

other risks that may be present. As some recent examples illustrate, resource nationalism can give rise to pitfalls for unwary governments.

Nigeria is a case in point. Rich in oil and gas resources, Nigeria has an established oil and gas industry, and has managed to attract investment notwithstanding the risks posed by political instability and civil unrest. In recent years, however, the Petroleum Industry Bill, designed to reform the industry and secure greater benefits to the nation, has cast a shadow over the industry. Proposed increases in the Government's share of revenue mean that many projects have stalled, as IOCs weigh up the increased risks against the likely rewards. In addition, a number of IOCs have exited out of existing developments.

Algeria is another country where the Government's efforts to secure greater control over the nation's natural resources have had undesirable consequences for the country's oil and gas industry. Algeria, together with Nigeria, is one of the biggest oil and gas producers in Africa. In 2006, the Government made various amendments to the existing hydrocarbons regime to make it less favourable to foreign investors. As a result, Algeria has experienced difficulties attracting IOCs in recent years. During recent licencing rounds, only 4 out of 16 blocks were awarded in 2008; 3 out of 8 in 2009; and 2 out of 10 in 2011. The lack of fiscal incentives were cited as the main reason for Hess's sale of the Bir el Msana exploration block to Cepsa.

In response, in 2013, Algeria's Parliament was forced to back-track and amend the existing petroleum legislation to offer greater fiscal incentives to IOCs investing in offshore exploration and unconventional resources. Whether this has been successful remains to be seen. The latest licencing round closes in Summer 2014. On its conclusion, the interest in the various blocks tendered will give a better indication of whether the latest amendments to Algeria's petroleum laws have appeased IOCs' concerns over Algeria's fiscal regime.

Events further afield in Brazil are a further illustration that a push too far by the state can backfire. The massive Brazilian offshore Libra oil field, which at first glance would seem a highly desirable asset for any IOC, failed to generate the expected level of interest because of the overly onerous fiscal terms imposed by the Government. Only 11 companies registered an interest in the field, and out of those 11 only one made a bid, which was only for the minimum eligible amount. Given that Libra's estimated reserves are between 8 and 12 billion barrels of recoverable oil, the reaction of IOCs to the proposed fiscal measures clearly showed that the regulatory pendulum swung too far in favour of the Government and failed to achieve the Government's objectives.

## Where to now for Africa?

It has been predicted by some commentators that the pushback by IOCs in countries such as Nigeria and Brazil will act as a trigger for a reversal of the resource nationalism trend. However, given the political and economic pressures faced by African nations, the road ahead may not be so clear. We would expect to continue to see ongoing changes to oil and gas regimes, which will no doubt in some instances fail to achieve the right balance. It may, as the saying goes, be a case of "two steps forward and one step back".

What is certain is that with so many IOCs seeking to invest in Africa, fiscal regimes and how states treat international investors will continue to be negotiated and scrutinised by all involved. African states will, rightly so, continue to look for ways to optimise the benefits from their rich resources, but, in doing so, they must be mindful of the need to achieve the right balance.



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## STOP PRESS:

# Ashurst advises on award-winning deals

At award ceremonies held earlier this year, Ashurst has been acknowledged in eight prize-winning deals at the Project Finance Europe and Africa Deals of the Year Awards and the Project Finance Latin America Deal of the Year Awards. In addition, we have also been awarded an "Advisor of the Year" award for Renewables at the Infrastructure Journal Awards.

Commenting on Ashurst's success, global head of energy, resources and infrastructure, Mark Elsey, said:

*"We are delighted to have been involved in some of the most complex and ground-breaking energy projects to have successfully closed over the last year. These deals demonstrate the breadth and quality of our practice and they reinforce our position as operating at the forefront of the wider projects market."*

### Project Finance Deals of the Year Awards:

- **Africa Solar Deal of the Year** – Ashurst advised ACWA Power on the commercial close and financing of the first phase of the Noor solar programme in Ouarzazate, Morocco
- **Africa Oil & Gas Upstream Deal of the Year** – Ashurst advised MODEC, Mitsui, Marubeni, and Mitsui O.S.K. Lines on their joint participation, through project company T.E.N. Ghana MV25, on a long-term charter of a floating production, storage, and offloading system to Tullow Ghana
- **Europe Onshore Wind Deal of the Year** – Ashurst advised Terra Firma-backed Infinis, the UK-based independent generator of renewable power, on the refinancing of its 274MW portfolio of wind farms

- **Europe Refinancing Deal of the Year** – Ashurst advised Trifinium Advisors (UK) Limited on the €1.43bn refinancing of the Castor underground gas storage, which was the first use of the European Investment Bank's project bond credit enhancement initiative
- **Middle East Oil & Gas Deal of the Year** – Ashurst advised Concord Energy Pte Ltd and its affiliates on the sale of a 50 per cent interest in Fujairah Oil Terminal FZC to Sinomart KTS Development Limited and FOT on the US\$251.86m limited recourse financing of the project
- **Europe Oil & Gas Deal of the Year** – Ashurst advised EnQuest on a new US\$1.7bn credit facility, underwritten by BNP Paribas and Scotiabank
- **Africa Wind Deal of the Year** – Ashurst advised the developer, Aeolus Kenya Limited, in relation to the development and financing of a 60MW onshore wind project in Kinangop, Kenya
- **Latin America Solar Deal of the Year** – Ashurst advised EverStream Energy Capital Management and Chilean family office represented by Claro Y Asociados on the acquisition of a majority share in the SPV owning the 50.7MW San Andres solar power plant project in Chile and on the US\$100.4m project financing by International Finance Corporation.

### Infrastructure Journal Awards:

- **Legal Advisor of the Year for Renewables** in recognition of our leading practice and in particular our work on the Noor 1 Project, Kinangop Wind Farm, Infinis Wind Farm refinancing and the Butendiek Wind Farm.

## Ashurst strengthens Middle East energy team with partner promotion



Ashurst is delighted to announce the appointment of Renad Younes as a partner in the firm and as the head of the Middle East oil and gas practice.

Renad joined Ashurst's energy, resources and infrastructure team in London in 2007 and moved to Abu Dhabi last autumn to head up the oil and gas practice in the Middle East.

Renad is a transactional lawyer who specialises in advising international energy companies, financial institutions and governments on international M&A transactions and projects across each of the upstream, midstream and downstream sectors, as

well as advising on LNG sale and purchase arrangements and LNG liquefaction and regasification projects.

Renad's recent experience includes advising on the acquisition of an interest in an upstream field offshore Turkmenistan valued at approximately US\$4bn; on the entry by Angola LNG Limited as a seller into a large number of LNG Master Sale and Purchase Agreements; on the acquisition by Gunvor of an interest in the TAL pipeline; on the Floating Storage and Regasification Unit of Lithuania's state-owned oil company; and on the proposed acquisition of an interest in the downstream business of United Petroleum in Australia. Other clients that Renad advises include Centrica, Dana Gas, Dyas, E.ON, Mitsui, Oil Search, OMV and Petrochemical Industries Company of Kuwait.

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112 www.ashurst.com.

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