

Infrastructure development, fuel security, carbon and competition: variables affecting European energy projects

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Key factors affect energy companies' strategy

- The need for infrastructure reinforcement: electricity generation: power transmission and gas transportation
- Fuel security: seeking diversity of supplier, source and fuel type
- Cost of fuel – price rises and volatility
- The environment: renewables, carbon etc
- Liberalisation and development of markets: unbundling / ISO; market opening

Inter-relationships

- There are at first sight some underlying tensions between these themes.
- Competition – open markets – changing market shares and structures – price pressure
- Capital investment and new technology – long term investments – stable pricing or long term contracts to support external financing
- Increased costs for carbon and renewable generation
- New structures and approaches are being developed to reconcile these factors effectively.

This is already seen in rules on pipelines and LNG facilities

- Operators of gas transportation infrastructure must normally offer open access.
- However, long term usage and shipping contracts are needed to support the financing required to build new facilities.
- These are allowed via exemption from open access rules - if shown to be necessary to get the infrastructure built and financed.
- Competitive concerns are addressed by requiring justification, an open season process, applying “use it or lose it” rules and setting limits on own use capacity.

Renewable energy sources

- Renewables need to be developed if applicable targets are to be met
- Absolute cost levels are high and economies of scale are needed if unit costs are to come down
- Ways are found to modify market pressures to encourage these forms of generation: tax incentives, supplier purchasing quotas, special feed in tariffs etc
- Do incentives just get passed up to the equipment manufacturers; will this change as new manufacturers come on line?

New build nuclear

- Nuclear power creates both advantages and risks in a competitive market; power companies need to find ways of dealing with these.
- Building nuclear power stations calls for access to major internal or external sources of finance.
- It is hard to build new nuclear power stations unless you have a secure long term offtake contracts and/or stable market share as a supplier.
- Interface with or support from government may be required on issues such as planning, the regime for financing decommissioning / storage etc

Nuclear - continued

- These features can raise competition and related issues which make it harder to develop nuclear power in developed liberalised markets
- Competition policy and law needs to recognise that capital costs can justify long term contracts and that some governmental involvement can be justified in establishing a workable framework
- Ways can be found to spread the need to commit to nuclear power across the market
- Contracts can in turn be structured in a way that allows for potential reallocation of capacity as markets and players' needs evolve, while still supporting financing

The practical effects of all of this

- The examples we have discussed, and many others, show it is possible, if not always easy, to attune competition objectives to the need to improve fuel security, reinforce infrastructure and meet environmental needs.
- So, what are energy companies doing to meet these challenges?
- How do different types of market participants vary in their approach and strategy?
- By participants we mean
 - Major European utilities
 - National energy companies
 - Financial investors / infrastructure funds etc
 - Others (governments, customers, oil majors etc)

What sorts of deals do we see clients doing?

Major transit pipelines – e.g. Nabucco

LNG terminals – e.g. Gate

New transmission lines

Acquisitions of energy companies in other countries

Privatisations of state owned energy businesses (Romania, Turkey etc)

Asset swaps between jurisdictions

Setting up trading operations in other countries

Cross border energy market rules - Ireland

New nuclear power stations – e.g. Ignalina

Thermal power stations – buying and building them

Wind farms e.g. the North Sea: Turkey

Solar power stations – southern Europe

Waste to energy projects

Bio-fuel projects

Clean coal

Emissions trading & projects

Oil majors developing new fuels and technologies

Refinancing old deals to release new resources

What does this involve?

- All this activity is designed to reinforce energy infrastructure, to achieve fuel security, and to achieve environmental targets
- All of it involves major costs
- It means passing on costs to customers and end users of energy
- It also involves making these developments attractive to sources of debt and equity finance
- Companies are differently placed in approaching these realities

Major utilities

- Major European utilities have traditionally been well placed to finance investment, particularly after consolidation and international expansion.
- These new investments needs arise at a time of increased competitive pressure in their traditional markets
- At the same time, they have to negotiate with powerful sellers of fuel from outside the EU to achieve diversity and fuel security.

Effects on the major utilities

- Major integrated utilities face
 - threats to their market share in home markets
 - investigation of alleged anti-competitive competitive practices / market structures
 - potential loss of ownership or control of their distribution networks in the medium term
- the merits are being debated and final outcomes are to be developed
- but the overall trend has implications for strategy

Major players – potential responses

- A rational long-term response for major players is to shift emphasis
 - from areas of threat (existing markets)
 - to areas of opportunity (new markets)

This shift produces:

- Some reduction over time in market share in home markets if circumstances so require
- Expansion by major players in markets where they have small or no market shares
 - cross border asset swaps with competitors
 - buying smaller energy companies in other countries
 - setting up new subsidiaries in other countries
- Exchanges of downstream assets / market share for access to upstream energy supplies

Opportunities and strengths

- Major energy companies have significant strengths
 - a diverse portfolio of assets often in a range of countries and sectors of the energy market
 - experience of major investment programmes and independent projects
 - strong credit ratings
 - access to the capital needed to finance new expenditure - so their participation is important in meeting the new needs
 - the capability to adapt their structure and activities to meet changing conditions

Other types of investor – from the energy industry

- Energy production / supply companies investing indirectly in transit infrastructure in other markets
- Primary fuel producers from outside the EU investing downstream and seeking market access in the EU
- Transmission companies expanding outside their existing markets
- Oil and gas majors expanding downstream and into new technology
- Industrial investors – e.g. co-generation

Financial investors

- Infrastructure funds
- Private equity funds
- Investment banks - commodities players
- Sovereign funds
- Others?

Different opportunities and needs in different parts of the EU

- Not all the opportunities lie in the established energy systems of Western Europe
- Eastern European energy systems all face need for expenditure on new generation, transmission and distribution and environmental technology
- In many ways their needs are greater due to older facilities and greater dependence on Russian energy sources
- Their financial resources are much smaller
- So they need to find ways of involving external sources of finance
- This happens just as policy developments give immediate neighbours and large European energy companies greater incentive to enter their markets

Sourcing capital for CEE energy markets

- Government controlled tenders – invite major energy companies to bid to become investors in projects or businesses with significant national ownership or control
- Project financing structures – local sponsors set up independent projects where other energy companies can become co-sponsors and where project financing or other private finance can be raised
- Joint ventures
- Hybrid structures combining elements of project and corporate financing techniques
- Involvement of financial investors – e.g. infrastructure funds in appropriate energy sectors (generation / transmission etc)

The picture going forward

- Large volumes of capital expenditure are needed to meet renewal, strategic and environmental objectives
- Cost alone should not determine the most desirable energy mix as, in policy terms, we attach increasing value to environmental and strategic benefits
- Market pressures will, without some adaptation, increase downward pressure on prices as technology and fuel costs rise
- New investment calls for longer term price stability and the recognition of the value of environmental benefits and fuel security, not just minimising costs
- Non EU countries with less developed competition rules may find it easier to make this sort of investment

Going forward...


- Liberalisation and unbundling may in some ways reduce traditional internal sources of investment in transmission infrastructure; yet they may also increase incentives to expand networks
- Pressure on incumbents may also result in changes in strategy that encourage spending more on acquisitions in other markets, not just investment in infrastructure
- Financial investors of various kinds will seek opportunities - in stable network assets and in non fossil generation and new technologies
- Oil majors and others will also expand into other forms of energy and new technologies
- All these variables will make for more active and diverse participation in energy projects which tackle a much more complex mix of economic, environmental, technological and strategic objectives in coming years.

Questions...

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