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The UK National Security and Investment Act: Key Implications for the Energy Sector

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Background

The UK's National Security and Investment Act 2021 (the "**Act**") entered into force on 4 January 2022, introducing a new investment control regime for acquisitions in the UK, with the aim of protecting the UK's national security. These new legislative powers follow a global trend of greater scrutiny over foreign direct investment, particularly in sectors that are seen as critical from a national security perspective.

The Act replaces the UK's previous foreign investment regime under the Enterprise Act 2002 and establishes a more thorough system for screening, and blocking, investments in certain parts of the UK's economy.

There has been considerable commentary on the Act as a whole in recent months. This article discusses the key implications of the Act specific to the UK's energy sector.

Key features of the Act

The Act has two key elements:

- a notification regime, pursuant to which transactions involving "trigger events" in certain key sectors are subject to mandatory notification, with the option to voluntarily notify transactions; and
- a power for the Secretary of State for Business, Enterprise and Industrial Strategy (the "**Secretary of State**") to "call-in" transactions for review.

Related People

Darren Spalding
Partner
LONDON
+44 (0) 20 7448 4209
darren.spalding@bracewell.com

Nicholas Neuberger
Partner
LONDON
+44 (0) 20 7448 4249
nicholas.neuberger@bracewell.com

Adam Quigley
Senior Associate
LONDON
+44 (0) 20 7448 4214
adam.quigley@bracewell.com

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Mandatory Notifications

The Act establishes a mandatory notification regime if a purchaser gains control of a "qualifying entity" or "qualifying asset" through the occurrence of a trigger event. Those trigger events are:

- a purchaser acquiring or increasing its share ownership in the qualifying entity to more than 25% (or if it crosses 50% or 75% thresholds from an ownership interest below that level);
- a purchaser acquiring or increasing its voting rights in the qualifying entity to more than 25% (or if it crosses 50% or 75% thresholds from a voting right interest below that level); or
- a purchaser acquiring voting rights in the qualifying entity enabling the purchaser (whether alone or together with other voting rights it holds) to secure or prevent the passage of any class of resolution governing the affairs of the qualifying entity.

The definition of "qualifying entity" is drafted broadly and captures UK companies, limited liability partnerships, partnerships, trusts and any other corporate body. An additional trigger event applies in respect of "qualifying assets," but the acquisition of assets are currently not within the scope of the mandatory notification regime (although the Act gives the Secretary of State the power to expand the scope of the mandatory notification regime to cover asset acquisitions).

The Act is supplemented by the National Security and Investment Act 2021 (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021/1264 (the "**Regulations**"), which specify the 17 sectors that fall within the scope of the mandatory notifications regime, set out in the table below.

Parties must obtain the approval of the Secretary of State for any notifiable transaction. Failure to obtain the Secretary of State's approval prior to completion of a transaction will render it void, although the Act does include a mechanism transaction for obtaining retrospective approval.

Voluntary Notifications

The Act also allows a purchaser to voluntarily notify a transaction that may not fall within the mandatory notification regime, but which may still give rise to national security concerns. An additional trigger event, the acquisition of material influence over the policy of a qualifying entity, is outside of the mandatory notification regime but may justify a voluntary notification. Parties can also make a voluntary notification in respect of an asset acquisition, which may be advisable if the asset transfer is perceived to pose a risk to national security.

By voluntarily notifying the Secretary of State of the transaction, the parties can obtain a decision as to whether the Secretary of State will exercise his or her call-in powers, providing parties with greater transaction certainty.

Call-in powers

The second key limb of the Act is the power of the Sectary of State to "call-in" a transaction for review, whether notified or not, if:

- a trigger event has occurred in relation to a "qualifying entity" or "qualifying asset" and the event has given, or may give rise to a risk to national security; or
- arrangements are in progress or contemplation which, if carried into effect, will result in a trigger event taking place in relation to a qualifying entity or qualifying asset, and the event may give rise to a risk to national security.

Note that, in addition to "qualifying entities," the Secretary of State may also exercise his or her call-in powers in relation to "qualifying assets". An additional trigger event applies in respect of qualifying assets only if a purchaser acquires a right or interest in, or in relation to, an asset, and as a result gains the ability to use, direct or control the asset, or use, direct or control the asset to a greater extent than prior to the acquisition. A "qualifying asset" includes land, tangible moveable property and ideas, information or techniques that have industrial, commercial or other economic value. Acquisitions of assets that are located outside of the United Kingdom or the territorial sea that is used in connection with activities carried out in the UK or the supply of goods or services to persons in the UK may also be called-in for review.

The term "national security" is not defined in the Act to give the Secretary of State discretion and flexibility to exercise the call-in powers in light of the various threats to national security that may arise. The Secretary of State has issued guidance on when the call-in powers are likely to be exercised. In deciding whether to exercise the call-in power, the Secretary of State will consider the following risk factors:

- ***Target risk*** – whether the target of the acquisition is being used, or could be used, in a way that has a risk to national security (with the 17 areas listed above creating a greater risk than other acquisitions);
- ***Purchaser risk*** – whether the purchaser has characteristics that suggest that there is, or may be, a risk to national security if the purchaser has control of the target (with the purchaser's sectors of activity, technological capabilities and links to entities that may seek to threaten or undermine the UK's national security likely to be considered); and
- ***Control risk*** – the level of control that has been, or will be, acquired through the acquisition (with higher levels of control likely to give a higher risk to national security).

The Secretary of State expects to call-in acquisitions that feature all three risk factors.

Following the issuance of a call-in notice, the Secretary of State will carry out a national security assessment. The Secretary of State may issue an interim order and then ultimately issue a final order in relation to the relevant transaction if the Secretary of State is satisfied, on the balance of probabilities, that a trigger event has taken place (or that there will be a trigger event) and a risk to national security has arisen, or would arise, from the trigger event, and that the provisions of the order are necessary and proportionate for the purpose of preventing, remedying or mitigating the risk.

A final order may impose conditions on the transaction or the parties, including to require the parties to do or not do particular things, and the Secretary of State may also block or unwind the transaction. To date, the Secretary of State has issued one final order to block a transaction. This was in respect of an intellectual property licencing agreement between the University of Manchester and Beijing Infinite Vision Technology Company Limited, due to the potential dual-use of the intellectual property such that it may be used to build defence or technological capabilities that may present a national security risk to the United Kingdom. Interestingly, the parties voluntarily notified the transaction because, as an asset transfer, it was outside the scope of the mandatory notification regime.

The Secretary of State's call-in powers also have retrospective effect and can be exercised in respect of any relevant transactions that completed between 12 November 2020 and 3 January 2022. To date, only three call-ins have been made public: the first relating to Nexperia's proposed acquisition of Newport Water Fab, the second relating to Altice acquiring 6% of the shares in BT and the third relating to Macquarie and British Columbia Investment Management Corporation's proposed acquisition of 60% of the National Grid's transmission business.

Nexperia is a Dutch entity owned by Chinese company Wingtech and the target, Newport Water Fab, is the UK's largest manufacturer of microchips, reportedly with several contracts with the UK Government, including in relation to defence. The call-in of this transaction is an example of target and purchaser risk, with Chinese control of a manufacturer of critical technologies with contracts with Government potentially posing national security concerns.

Timeframe for reviewing transactions

Transactions that are notified (either voluntarily or due to mandatory notification obligations) are subject to an initial screening, during which the Investment Security Unit (the "**ISU**"), on behalf of the Secretary of State, will consider whether the risk factors set out above will apply. The Secretary of State must then exercise the call-in powers within 30 working days of notification.

Following the issuance of a call-in notice, there is a period of 30 working days (extendable by a further 45 working days if the Secretary of State determines that there is a national security risk and further time is necessary to assess the transaction) in order to complete the national security assessment and either approve the transaction or impose an order.

Sanctions and consequences of failing to comply with the Act

A notifiable transaction that completes without the approval of the Secretary of State is void, meaning that failure to comply with the Act could create serious commercial consequences. The Act also contains a suite of offences, including:

- for completing a notifiable transaction without approval from the Secretary of State;
- for failure to comply with an interim or final order made under the Act;
- in relation to the supply of information to the Secretary of State and the attendance of witnesses; and
- unauthorised disclosure of information provided by the Secretary of State under the Act.

The Act provides that where a corporate entity commits an offence under the Act with the consent an officer (including a director, member of its management committee, chief executive, manager, company secretary or similar person), or due to the neglect of an officer, the officer is also guilty of the relevant offence and is personally liable.

The sanctions for the two key offences – completion of a notifiable transaction without approval and breach of an interim or final order – are subject to a maximum financial penalty of the higher of £10 million or 5% of total worldwide turnover where a corporate entity has committed the offence and £10 million where the offence is committed by an individual. The sanctions where an individual commits the two key offences are:

- on summary conviction in England and Wales, to imprisonment for a term not exceeding 12 months, or a fine, or both; and
- on conviction on indictment in England and Wales, to imprisonment for a term not exceeding 5 years, or a fine, or both.

Application to the energy sector

The Regulations set out four categories in relation the energy sector:

- upstream oil and gas, in relation to qualifying entities involved with upstream petroleum facilities, such as terminals, pipelines and related infrastructure and those with a petroleum licence under section 3 of the Petroleum Act 1998;

- downstream oil, in relation to qualifying entities involved in the import, storage and transportation of crude oil in the UK, as well as the import, refining, storage and distribution of refined products in the UK;
- downstream gas, in relation to qualifying entities involved in onshore processing, transportation and distribution of natural gas, including owners and operators of liquefied natural gas ("**LNG**") infrastructure; and
- electricity, relating to onshore and offshore generation, storage, aggregation, transmission and distribution of electricity across Great Britain (but excluding Northern Ireland).

Upstream oil and gas

The following qualifying entities meet the specified descriptions for the purposes of the upstream oil and gas sector:

- qualifying entities that own, operate, or enable the operation of an upstream petroleum facility;
- qualifying entities that develop or enable the development of an upstream petroleum facility (for "new" facilities only, being those under construction or that have commenced operations in the previous 12 months); or
- qualifying entities that hold a licence for an upstream petroleum facility under section 2 of the Petroleum (Production) Act 1934 or section 3 of the Petroleum Act 1998.

However, there is a materiality threshold determined by the throughput of the relevant upstream petroleum facility, such that an entity is only a "qualifying entity" if the relevant upstream petroleum facility:

- has a throughput of more than 3 million tonnes of oil equivalent in the 12 calendar months preceding the month in which the purchaser gains control (or the first 12 calendar months of operation if it is a new facility); and
- the upstream petroleum facility is situated in whole or in part in the United Kingdom, or is used in connection with the supply of petroleum to persons in the United Kingdom.

For the purposes of the Regulations, "upstream petroleum facility" means any terminal (excluding gas processing facilities in the United Kingdom or LNG import or export facilities), upstream petroleum pipeline (excluding interconnectors) or unit of infrastructure that is or will be necessary for the purposes of a petroleum production project carried out by virtue of a licence granted under section 2 of the Petroleum (Production) Act 1934 or section 3 of the Petroleum Production Act 1998.

As a result, any qualifying entity that either holds a licence for the exploration, drilling and production of petroleum in the UK or is an owner, operator or enables the operation of any infrastructure related to or necessary for

exploration, drilling or production that meets the throughput and nexus tests will be within the scope of the mandatory notification regime.

Based on a conversion factor of 1 tonne of oil equivalent to 6.84357 barrels of oil equivalent ("**boe**"), facilities that have an annual throughput of 20,530,710 boe or 56,250 boe/day will be captured – meaning that the larger participants in production activities in the UK North Sea and much of the associated petroleum infrastructure would satisfy this test.

Downstream oil

The following qualifying entities are relevant for the purposes of the downstream oil sector:

- qualifying entities engaged in the import or storage of any crude oil, intermediates, components or finished fuels;
- qualifying entities engaged in the production of intermediates, components or finished fuels through refining or blending processes;
- qualifying entities engaged in the distribution of petroleum-based fuels to storage sites by road, pipeline, rail or ship; and
- qualifying entities engaged in the delivery of petroleum-based fuels to retail sites, airports or end users.

There is again a materiality test in order for an entity to constitute a "qualifying entity", assessed by reference to the qualifying entity's capacity in one of the previous three calendar years:

- if it had a capacity of greater than 500,000 tonnes; or
- if it owned a facility with a capacity of greater than 50,000 tonnes.

Downstream oil activities and capacities are viewed in the aggregate under the Regulations, such that an entity that imported 400,000 tonnes of finished fuel in 2020, imported a further 450,000 tonnes of fuel and produced 75,000 tonnes of finished fuel in 2021 and imported 400,000 tonnes of fuel in 2022 is deemed to have a capacity of 525,000 tonnes due to its 2021 capacity. The relevant qualifying entity would therefore satisfy the capacity tests notwithstanding that it did not meet the threshold for importing or production alone and only did so in one of the previous three calendar years.

Downstream gas

The following qualifying entities are within the scope of the Regulations in relation to the downstream gas sector:

- qualifying entities holding a gas transmission licence, distribution licence, interconnecter licence or exemption under section 7 or 7ZA of the Gas Act 1986;

- qualifying entities that own or operate a gas processing facility in Great Britain which has the capacity to process more than 6 million cubic metres of gas per day; and
- qualifying entities that own or operate an LNG import or export facility (noting that the UK does not have any LNG export facilities at present) which has the capacity to process more than 6 million cubic metres of gas per day.

Electricity

The following qualifying entities are within the scope of the Regulations in relation to the electricity market:

- qualifying entities holding a transmission licence, distribution licence or interconnecter licence under section 6 of the Electricity Act 1989 (the "**Electricity Act**") or carrying on any activity under an exemption granted in respect of section 4(1)(b), 4(1)(bb) or 4(1)(d) of the Electricity Act pursuant to section 5(1) of the Electricity Act;
- qualifying entities holding a generation licence under section 6 of the Electricity Act or carrying on any activity in pursuance of an exemption from section 4(1)(a) of the Electricity Act granted to the qualifying entity by order under section 5(1) of the Electricity Act; or
- qualifying entities carrying on "aggregation", the activity of combining multiple customer loads or generated electricity for sale, purchase or auction in the electricity market of Great Britain.

In the case of generators and aggregators there is a material test and the qualifying entity must meet either of the following conditions:

- the qualifying entity is an owner or operator of any individual generating asset that has a total installed capacity equal to or greater than 100 megawatts; or
- the "relevant capacity" of the qualifying entity is equal to or greater than 1 gigawatt. The term "relevant capacity" is defined broadly to cover the electricity generation and aggregation capacity of the qualifying entity that is the subject of the acquisition and also that of the purchaser and its affiliates.

The relatively low threshold of 100 megawatts means that acquisitions of utility-scale electricity generating projects will most likely be caught within the scope of the specified descriptions and will be notifiable transactions if a trigger event occurs. It is a slight quirk that the capacity requirements refer to "total installed capacity", meaning that projects in the construction phase that have not started generating electricity are not caught by the 100 megawatt threshold, even if the relevant project will have a much greater capacity once it commences commercial operations. Investors should be wary of the "relevant capacity" test given that the test is cumulative encompassing both the purchaser's group and the target, as well as both generation and aggregation activities.

Implications for participants in the energy sector

M&A

The Secretary of State has stated that the Act should not be viewed as a barrier or deterrent to investment in the UK. Nonetheless, investors considering the acquisition of UK companies and assets will need to carefully consider whether proposed transactions are within the scope of the Act given the serious consequences of failing to comply with the mandatory notification regime and any order issued by the Secretary of State. This is particularly the case for investors in the energy sector given the broad specified descriptions set out in the Regulations, meaning that acquisitions of companies operating in the UK oil and gas and electricity sectors will often be in the scope of the mandatory notifications regime. The application of the Act to a transaction and the requirement to make a mandatory notification will likely have timing and economic consequences for parties that will need to be considered as part of the overall timeline and expenditure on transaction costs when considering whether to proceed with an acquisition.

From a contractual perspective, sale and purchase agreements now typically contain conditions precedent regarding the non-application of the Act to the relevant transaction. Sale and purchase agreements should also consider addressing the risk allocation as between buyer and seller if the Secretary of State issues an interim or final order that prevents the relevant transaction from completing or has the effect of altering the economics or desirability of the relevant transaction.

Notably, asset transfers are outside of the mandatory notification regime. As a result, asset transfers of UK energy assets – such as an interest in a petroleum licence and joint operating agreement or similar interests, which is a typical transaction structure in the UK North Sea – would not be subject to the mandatory notification regime. However, such transactions are still subject to the Secretary of State's call-in power if the trigger event relating to asset acquisitions occurs (as would likely be the case in respect of a transfer of a participating interest in a petroleum licence and joint operating agreement). The risk of a call-in is minimal if the transaction is unlikely to give rise to national security concerns.

However, given the Russian invasion of Ukraine and subsequent focus on energy security as a key element of the UK's national security more generally, transactions in the energy sector involving foreign purchasers can reasonably be expected to come under greater scrutiny from Government. The Secretary of State's recent decision to call-in Macquarie and British Columbia Investment Management Corporation's proposed acquisition of 60% of the National Grid's transmission business can be seen as evidence of the increased scrutiny of foreign ownership of critical energy infrastructure in the UK, notwithstanding

that both Macquarie and British Columbia Investment Management Corporation already own utilities and other infrastructure in the UK.

In the upstream, such transactions may also be subject to the consent of the North Sea Transition Authority in any event, such that there is an effective block on transactions posing a threat to national security outside of the scope of the Act.

In order to mitigate the risk of a call-in notice being issued in respect of a transaction, parties should consider engaging in dialogue with the ISU in order to obtain an initial view of whether a transaction falls within the scope of the mandatory notification regime.

Finally, investors should also note that the Act is not a pure foreign investment regime and applies equally to domestic UK acquirers. The provisions of the Act, therefore, cannot be circumvented by the incorporation of a UK 'bidco' or purchaser entity.

Debt finance

Importantly, the Act can have major implications for lenders to UK projects. A loan in itself is unlikely to fall within the scope of the regime and the Government has recently issued guidance that the granting of an equitable interest over shares 'would not appear to grant any control over the shares … until the happening of an event that would provide control'. On this basis, whilst the granting of security over shares is unlikely to be notifiable, the enforcement of security over shares in a qualifying entity of a specified description by a security agent or trustee on behalf of secured creditors will fall within the scope of the Act's mandatory notification regime.

There is an important distinction with respect to Scots law security where title to shares is transferred to a security trustee at the point of taking the security, rather than upon enforcement as would be the case under English law. The Government has confirmed that such security would fall within the scope of the mandatory notification regime if the entity that is the subject of the share security is a qualifying entity of a specified description.

The Act should therefore be considered by lenders and borrowers not only in relation to the initial grant of the loan and security (which are less likely to fall within the scope of the Act), but also in the context of the enforcement of security by the security agent or trustee, and then again on any subsequent sale of the relevant shares or assets by that security agent or trustee to a third party (which are more likely to fall within the scope of the Act).

Project development

The Government has recently issued guidance on the applicability of the Act to the development of new build infrastructure in the downstream gas and electricity sectors. The Government considers that the scope of the Secretary of State's call-in powers includes the granting of a right or licence, or the

submission of a bid for a licence (such as a generation licence from Ofgem) or entry into a grid connection agreement with National Grid, on the basis that:

- such licences and contracts are qualifying assets; and
- the application for the relevant qualifying asset or the award constitutes the commencement of arrangements to acquire control over a qualifying asset or the acquisition of control over the qualifying asset, respectively.

As asset acquisitions, these transactions are outside of the scope of the mandatory notification regime but may be voluntarily notified to the Secretary of State. Project developers will need to consider the risk that their bid for a licence to develop an asset or for a grid connection agreement or similar arrangement will be the subject of a call-in by the Secretary of State given the potentially significant development costs that will be incurred and would likely be unrecoverable in the event that the relevant acquisition were to be blocked by the Secretary of State. This might encourage an increase in cautious early voluntary notifications to avoid such risks. The guidance re-iterates that the Secretary of State will only call-in a transaction if it has a reasonable suspicion that the acquisition may pose a risk to national security and therefore, based on practice to date, we would anticipate that very few acquisitions of qualifying assets in this context will be subject to call-in by the Secretary of State.

Conclusions

As is common following the enactment of any significant legislation, companies undertaking acquisitions in the UK energy sector are, in our experience, taking a cautious approach to the analysis of the new regime. A form of “standard practice” will inevitably emerge as companies, advisers and the regulators (the ISU and the Secretary of State) become more familiar with its operation. In the meantime, participants considering sales and acquisitions in the UK energy sector should be mindful of the Act’s implications, and the potentially significant applicable penalties for contravention, by ensuring that analysis and any necessary filings are built into the transaction timetable, as is customarily the case for other regulatory approvals.