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Client Alert

Energy & Natural Resources

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Due diligence for energy and commodity asset acquisitions: regulatory considerations

At a Glance…

Due diligence for energy and commodity asset acquisitions: regulatory considerations

This is the third article in our series, focusing on mergers and acquisitions in the energy and commodities sector. The first article covered key issues relevant to acquiring business assets, and trading portfolios, across the energy and commodities sector. The second article looked at the main issues to consider in relation to asset acquisitions in the 'soft' commodities sector.

In this article, we consider the Top 10 headline regulatory considerations, focusing on issues arising under English and EU law that need to be taken into account when conducting an asset or portfolio acquisition or disposal. While the first seven issues are particularly relevant in respect of assets and portfolios in the energy and commodities sphere, the remaining issues are of a more general and overarching nature, but should, nevertheless, be borne in mind when conducting transactions in this sphere.

There may, of course, be other considerations that need to be explored, depending on the nature of the target.

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	Issue	What to consider
1.	Financial Services Licences and the Markets in Financial Instruments Directive (2014/65/EC) (MiFID II)	An entity purchasing a trading participant will need to ensure that it has any financial services licences needed to perform the trades. For example, an entity that provides investment services, or performs investment activities, in relation to financial instruments may need to be regulated under the MiFID II regime (unless it can rely on an exemption). Financial instruments include, inter alia, various types of commodity derivative contracts (including some physical contracts treated as derivatives), transferable securities and emission allowances and derivatives thereof. In the UK, these entities will be authorised under the Financial Services and Markets Act 2000 (FSMA) (unless they can rely on an exclusion) and will be regulated by either the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA). If the target entity is an authorised firm, the purchaser will need to ensure that it has the requisite systems and controls necessary to be able to acquire and run an authorised entity. It also will need to obtain regulatory consent (see 7. below). Appropriate analysis needs to be conducted around scoping and 'future proofing' the post-acquisition shape the business will take. Furthermore, certain purchasers may need to seek authorisation under the MiFID II and domestic regime, prior to acquiring a trading portfolio, if the volume of trades undertaken by the target results in the purchaser being unable to avail of an exemption from authorisation under MiFID II. Authorisation may take between 6-9 months. Therefore, if relevant, such timescales need to be factored into the transaction timetable, and completion needs to be managed accordingly. MiFID II introduces position limits that will apply to commodity derivatives traded on trading venues, and to economically equivalent over-the-counter (EEOTC) contracts. A purchaser will have to assess whether, following its acquisition, its trading activities in exchange contracts and EEOTC contracts will exceed the set position limit. It is worth noting, that non-financial entities are eligible to apply for a hedging exemption. It will be necessary to complete an application in respect of each commodity derivative contract for which an exemption is sought. Therefore, a purchaser that is (and remains, post-acquisition) a non-financial entity should consider whether it will need to apply for any exemptions to the position limits.

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2.	The Regulation on Wholesale Energy Market Integrity and Transparency (Regulation (EU) No 1227/2011) (REMIT)	If the target trades in the EU power or gas markets, including LNG and biogas (known as 'wholesale energy markets'), it will be subject to REMIT. To the extent that a purchaser acquires a portfolio of business that includes wholesale energy products, then it will need to register with the relevant national competent authority (in the UK's case, Ofgem), in order to be able to continue to trade those products. Consideration should be given to the sector-specific nature of this regulatory requirement and whether or not the acquirer feels comfortable and/or able to deal with the added reporting, trading and transparency requirements, standards and burden imposed by REMIT. Being subject to REMIT means, in many EU Member States, its market behaviour is subject to the purview of the energy regulator, as well as the financial services regulator and competition authorities. Therefore, the acquirer needs to feel comfortable with being under the auspices of several distinct regulators with separate powers and enforcement rights.
3.	The Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (Regulation (EU) No 648/2012) (EMIR)	Under EMIR, parties trading derivative contracts are required to report details of any such contracts that have been concluded, and of any modification or termination of the contract. Depending on the portfolio of contracts being acquired, it may be necessary to report the acquisition, given that the acquisition could constitute a modification to an existing contract (for example, if the contract is novated from the seller to the buyer). A legal entity identifier (LEI) is required in order to report the details of these contracts. An LEI can be obtained from an LEI issuer, also known as a local operating unit. The application process will normally take a few of days, and the LEI will need to be renewed each year (which will incur an additional (nominal) fee). A purchaser will need to ensure that it has an LEI prior to trading and that it is able to report the details of the modified trades (for example, novated trades) as soon as the acquisition has been finalised and the reportable event has occurred. Reporting of derivative contracts can be done pursuant to the terms of a delegated reporting agreement, but it requires the entity delegating the reporting having the systems and controls necessary to be able to monitor the information that is being reported to the relevant competent authority.

	Issue	What to consider
4.	The Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts or to Measure the Performance of Investment Funds (Regulation (EU) 2016/1011) (Benchmark Regulation)	The Benchmark Regulation came into force on 1 January 2018, and it governs the submission of information to benchmarks and the operation of benchmarks by administrators. If a purchaser acquires a benchmark administrator, it will become subject to the regime and will need to be aware of its rules and regulations. At a high level, a benchmark administrator will need to be authorised and regulated by the national competent authority (in the UK, this is the FCA). In addition, a purchaser of an entity that submits information to benchmarks will need to comply with rules on governance and control of information to be submitted, although it will not be required to be authorised. The contributing entity will need to establish policies as well as systems and controls to ensure the submissions are compliant with the requirements of the Benchmark Regulation (for example, record keeping requirements). Policies and procedures will need to be updated to ensure that they comply with the Benchmark Regulation and accurately reflect commercial reality.
5.	Environmental notification and/or permission	A purchaser may need to consider whether any environmental notifications or permissions are required when purchasing assets which contain dangerous substances or are built on a site that is deemed to be hazardous. One such regime which a purchaser will need to be aware of is the Control of Major Accident Hazards Regulations (COMAH), which applies to any 'establishment' that manufactures, stores or uses a dangerous substance (for example, LNG or petroleum products) above a certain threshold. Operators of existing 'establishments' will have to report information to the regulatory authority, the Health and Safety Executive (HSE). The operator of a new establishment also will need to notify certain information to the HSE, although this is a lengthier process and will normally take three to four months. It is a criminal offence to operate a site that is subject to the COMAH regime without making the required notifications. Extensive due diligence should be undertaken to identify risks, and the sale and purchase documents should include indemnities and warranties tailored to those risks.

	Issue	What to consider
6.	European Atomic Energy Community (Euratom)	Euratom was established by the Euratom Treaty of 1957, which gives Euratom an exclusive right to 'conclude' supply contracts of nuclear material (for example, uranium). A supply contract includes, inter alia, a purchase, sale, exchange or loan contract. Therefore, a sale and purchase agreement, or an asset purchase agreement, may be considered a supply contract for these purposes. Parties to contracts for the supply of nuclear material are required to submit the contract to Euratom for its approval. This is an ongoing requirement, not just a requirement at the point of acquisition. If Euratom approves the contract, it will become a signatory to the contract. Any assignment, amendment or termination of the contract also will require Euratom's approval. This will need to be taken into account when conducting due diligence on supply contracts of nuclear material, particularly if the purchaser intends to take assignment of any such contracts. For more information on Euratom, please see our client alert on this subject. Separately, nuclear products are considered to be a high-risk product for the purpose of assessing the level of due diligence that needs to be carried out when performing know your customer (KYC) checks on counterparties. When acquiring a nuclear trading business, a purchaser should be aware of the additional operational and onboarding requirements that will be imposed, from a KYC perspective.

	Issue	What to consider
7.	Change of control	A purchaser will need to take into account any notifications that will need to be made as a result of a change in control of the target entity, or its assets. By way of example, an entity that holds an Ofgem licence for the supply of electricity or gas will need to apply for the licence to be transferred if the sale is structured as a business or asset sale and the legal entity holding the licence is to change. When considering whether to approve the transfer, Ofgem will apply the same criteria as those applied as if they were granting a new licence. Ofgem will publish a notification that it is proposing to consent to the transfer of a licence, allowing for at least two months for representations or objections before consent is actually given. The parties will need to be aware of this additional time, particularly if the buyer wishes to commence such activities immediately after conclusion of the transaction. In addition, if the target business is authorised and regulated under FSMA, then a purchaser who acquires ‘control’ of the target is required to seek consent from the FCA or the PRA (as applicable) before purchasing that entity, under the FSMA change of control regime. ‘Control’ of a firm may arise on acquiring 10% of the voting capital of the entity in question. The change of control notification requires new controllers to report, as a minimum, a strategic developmental plan, information on the impact of the acquisition on the corporate governance of the target firm, a due diligence report highlighting risks identified and proposed mitigation steps, along with various other pieces of information. Purchasers who are increasing their control in a target may also have to seek consent from the regulator if the level of control increases over certain thresholds. This is something that needs to be continually monitored, whenever any of the other shareholders with control dispose of their shareholding. It is a criminal offence to acquire or increase control without obtaining prior approval.

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8.	Competition	The UK's Competition and Markets Authority (CMA) has the ability to terminate a transaction or require the sale of some assets if it finds a merger is in breach of competition rules. Notification of the transaction to the CMA is voluntary. However, the CMA encourages parties to notify them as early as possible to avoid transactions needing to be unwound at a later stage, even after they have been concluded. If the acquisition or merger involves entities or assets in multiple EU Member States, and the market share of the target and purchaser post-completion exceeds certain thresholds, it will be necessary to notify the transaction to the EU Commission, and the Commission's approval will need to be granted, prior to completion of the acquisition. Unlike notification to the CMA, notification to the EU Commission is mandatory for any acquisition or merger that meets the criteria for notification. Both the CMA's and the EU Commission's review of a merger or transaction potentially is a two-phase process. The CMA has 40 working days to complete its Phase One investigation and a further 24 weeks if it decides to refer the transaction to Phase Two. The EU Commission has 25 working days to conduct its initial Phase One investigation, and a further 90 working days for Phase Two investigations; however, this may be extended if the parties need to submit more information, or if the transaction is particularly complex. Parties will need to be aware of the additional time that may need to be built into the transaction execution and completion timetable if there are any competition concerns. It is important to carry out the relevant antitrust assessment, to ascertain any notification requirements, at the outset of the transaction. For multi-jurisdictional transactions outside of the UK and/or EU which trigger notification, it is important to ascertain antitrust requirements for each jurisdiction (for example, Hart-Scott-Rodino in the United States).
9.	Senior Managers and Certification Regime (SMCR)	Under the SMCR, senior managers will fall into one or more of the Senior Management Functions and will have a statutory duty to prevent regulatory breaches in their area or areas of responsibility. This may require senior personnel of the purchaser to take on additional responsibilities and potential personal liability. The SMCR came into force for all FSMA 'relevant authorised persons' on 7 March 2016 and will be extended to almost all 'authorised persons' during 2018. The purchaser of an authorised firm will need to create a plan, setting out the individuals that will perform which Senior Management Functions. This will need to be pre-approved by the FCA or the PRA before that individual is able to commence their role. Other positions may also require internal certification. These certified persons will become subject to FCA and PRA (as applicable) rules and sanctions. Firms will need to certify that senior managers are suitable to do their jobs, at least once a year. Therefore, this is an ongoing requirement and not a one-off to consider at the time of acquisition.

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10.	Regulatory capital	Authorised firms will be required to hold a certain amount of capital at all times, known as regulatory capital. The amount that needs to be held will depend on the regulated activities that are being undertaken and the type and extent of the risks the firm is subject to. For example, firms dealing on own account but that are not authorised to hold client money will be required to hold a base amount of at least €50,000; whereas firms with the same permissions holding client money will need to hold at least €125,000. Operators of a multilateral trading facility, or organised trading facility, will need to hold at least €730,000. Insurance firms and banks, among others, will have different (and normally higher) capital requirements. The actual amount required to be held may be even higher depending on the extent and size of the business. Purchasers should be aware of this requirement, as it may affect the return on capital and cash flow considerations post-acquisition. In addition, a purchaser that is already regulated may need to adjust its own regulatory capital post-acquisition, if its permissions, or risk exposure, change following the purchase.