

Balfour Beatty Capital Limited

350 Euston Road
Regent's Place
London
NW1 3AX

Tel: 020 7121 3700
Fax: 020 7121 3701

www.bbcap.co.uk

Third Package Consultation Team
Department of Energy and Climate Change
Area 4C
3 Whitehall Place
London SW1A 2HD
By email: third.package@decc.gsi.gov.uk [REDACTED]

19 October 2010

Dear Sirs,

Response to DECC's Consultation on the Implementation of the EU Third Internal Energy Package

We refer to the Department of Energy and Climate Change's (DECC) Consultation on the Implementation of the EU Third Internal Energy Package (the **Consultation**) published in July 2010. We welcome the Consultation on the introduction of Article 9 of the Directive 2009/72/EC (the **Third Package**) and the opportunity to provide input to DECC on certain of the issues raised in Chapter 2 (Transmission and Distribution Networks) in the Consultation.

Introduction to Balfour Beatty

Balfour Beatty is a global infrastructure business with more than 50,000 employees providing professional, construction and support services and infrastructure investment in over 100 countries. Over the last 15 years we have developed an infrastructure investments' business that is a market leader in the provision of privately-financed projects across the world. These are high-value, long-term, complex and innovative projects, delivered through our international network of specialist companies. Our investment portfolio spans a number of sectors and notably, in the context of the Consultation, includes assets which generate electricity including (for the sake of providing examples) a:

1. 25.5% interest in Barking power station;
2. 50% interest in Edinburgh Royal Infirmary including an on-site CHP facility;
3. 25% interest in Powerlink (providing electricity to the London Underground) including back-up generation in case the main power supply is interrupted; and



Balfour Beatty Capital Limited, registered in England & Wales
No. 2423466, registered office: 350 Euston Road, London NW1 3AX,
an agent of Balfour Beatty Group Limited, registered No. 101073,
registered office: 130 Wilton Road, London SW1V 1LQ

4. variety of assets (hospitals, schools and airports) which have back-up generation facilities but which do not export electricity onto the national grid.

Balfour Beatty and the OFTO Tender Process

As you may be aware, Balfour Beatty has recently been appointed as preferred bidder by the Office of Gas and Electricity Markets (**Ofgem**) in respect of the tender process for the award of an offshore electricity transmission owner licence (the **OFTO Licence**) for the transmission assets connecting the Thanet offshore wind farm to the national grid. The OFTO Licence will be held by a special purpose vehicle established and owned by Balfour Beatty for the purpose of owning and operating the transmission assets (the **OFTO**). Therefore, Balfour Beatty will soon be adding a sub-sea transmission system to its investment portfolio.

Balfour Beatty's involvement in the future rounds of the OFTO tender process ("Transitional 2" and "Enduring") forms a core part of Balfour Beatty's future strategy for growth both in terms of investment in and ownership of offshore transmission assets and across the wider value chain. Balfour Beatty is also pursuing a variety of other investment opportunities in the renewable energy generation sector including on-shore wind, biomass and energy from waste. As such, Balfour Beatty aspires to be a key player at the forefront of the development of, and investment in, the UK's renewable energy sector.

Balfour Beatty's ambitions to invest in offshore transmission assets and renewable generation assets is aligned with the UK's commitment under the EU Renewable Energy Directive to generate 15% of the UK's energy from renewable sources by 2020. Allowing private sector investors to hold an investment portfolio which includes appropriate investments in transmission and generation assets will be key to securing the level of investment required for the UK to meet its renewable energy commitments by 2020 and to achieve the policy objectives of the Third Package – namely to enhance consumer protection, improve the functioning of the energy markets and increase security of supply.

Purpose of Transmission Unbundling

We note that transmission unbundling (as stated in paragraph 2.4 of the Consultation) is required "to remove any conflict of interest for energy companies involved in such operations. In particular, implementation of ownership unbundling or one of the derogations "should remove the incentive for vertically integrated undertakings to discriminate against competitors as regards access to the network, as regards access to commercially relevant information and as regards investments in the network". Balfour Beatty fully supports this policy objective not least as Balfour Beatty aspires to be a leading investor in the UK's electricity network and welcomes any legislation which enhances access to investment opportunities.

Application of the Third Package to OFTOs

We note at paragraph 2.34 of the Consultation that DECC confirms that "once built and licensed, offshore transmission infrastructure will need to meet the unbundling requirements of article 9 unless a derogation (or exemption) applies".

On the basis that Balfour Beatty will soon add a transmission system (Thanet OFTO) to its investment portfolio, Balfour Beatty has been considering the implications of the implementation of the Third Package on its wider portfolio. Balfour Beatty is concerned that if an overly prescriptive approach to the interpretation of the Third Package is taken, as identified by Ofgem, its ability to secure certification for

Balfour Beatty

Capital

any transmission system operator (TSO) which it owns from 3 March 2012 may be frustrated – this would not be the result that the legislation was intended to achieve.

Application of the Third Package on Balfour Beatty

Balfour Beatty invests equity on the basis that it always retains the right to appoint one or more directors on all of the boards of its investment companies and, as an active shareholder, reserves the right to restrict key management decisions by the exercise of shareholder rights in order to protect the value of its investments.

Our understanding of the Third Directive is that it is intended to prevent a person exercising a right in violation of the rules of ownership unbundling, but that appropriate minority interests are permissible. The EU Council has stated that it is appropriate not to exclude minority shareholding of a producer/supplier in ownership unbundled TSOs so long as this does not entail any control or any influence of one on the other and cannot lead to a conflict of interest.

Further, our understanding of the reference to the functions of generation or supply is intended to capture those which could have a material effect on the market, and not to encompass small scale generation (such as an on-site CHP facility) which is primarily intended to meet local demand (and may not even involve export onto the national grid for consumption by consumers).

Given that Balfour Beatty will own and exercise rights in respect of a TSO (Thanet OFTO) and also in respect of the entities within its current investment portfolio which generate electricity (Barking power station, Edinburgh Royal Infirmary and other accommodation assets with back-up power generation capability), Ofgem (assuming it will be designated as the national regulatory authority by DECC) may be unable to certify on 3 March 2012 that Thanet OFTO is in compliance with the unbundling requirements set out in the Third Package unless a purposive (as opposed to literal) approach is adopted to the implementation of the Third Package.

It is our understanding that the risk that the OFTO will not be certified will exist whether or not DECC implements the "full unbundling" or the "TSO" model (as Thanet OFTO's transmission assets did not exist on 3 September 2009). However we are also concerned that the demarcation of 3 September 2009 may discriminate between existing market players (which will be allowed to continue to hold existing investments in transmission and generation assets) and new entrants such as Balfour Beatty (which will not be entitled to add new transmission assets to its portfolio which were not constructed on 3 September 2009).

We would be concerned if the UK were to implement the Directive in a manner which did not allow the holding company of an OFTO to hold, elsewhere in its group, a minority interest in a generator (such as a 25.5% interest in Barking power station) or indeed a controlling interest in, for example, a hospital with a small on site generation capacity such as a combined heat and power plant, let alone install solar panels which generate electricity on any of its buildings.

Clearly, it cannot be the aim of the European Commission, DECC nor Ofgem to prevent new entrants holding a mixture of transmission and generation assets in their portfolio in ways that do not give rise to conflicts of interest or incentives to discriminate against competitors in access to the transmission system and nor can it be in the public interest to severely restrict the universe of bidders for future offshore transmission licences which will result in less competitive tender processes and, ultimately, higher prices for consumers.

Conclusion

We agree with the concern expressed by Ofgem in its Third Package Consultation 97/10 of 29 July 2010 in paragraph 1.15 *"that, read literally, the lack of qualifications in the prohibitions could render them unworkable and unenforceable"*.

We understand that the rules on unbundling as set out in the Third Package can (given that the very nature of the legal instrument at issue, a directive) be implemented in national legal orders in a variety of ways, as long as the goals of the directive are secured, and that each member state has some flexibility in how it adopts the directive into its national legislation.

We also understand that other EU member states, such as Germany, are in the process of considering the proper interpretation of the Third Directive and that the German Federal Ministry of Economic Affairs, is not inclined to interpret Article 9 as requiring no voting rights whatsoever and is instead focused on the effect that the exercise the rights would have on the operation of the relevant business.

We would ask DECC to implement the prohibitions in the Third Directive in a purposive manner. Otherwise the result of the Third Directive would seem to be that existing large vertically integrated undertakings can continue their businesses unaffected, whilst new entrants to the transmission business, such as Balfour Beatty and any other corporate groups with stakes in assets with, often very limited, electricity generation capability are disproportionately disadvantaged. This in turn will restrict the universe of bidders able to bid for future offshore transmission licences which will ultimately disadvantage consumers.

In implementing the directive into national law, a member state is entitled to adopt some flexibility as long as the objectives of the directive are not jeopardised.

Next steps

We would welcome the opportunity to discuss further with you the intended mechanisms to implement the Third Directive in a way which can achieve its stated objectives but does not cut across other appropriate investment interests that do not give rise to a conflict of interest that would affect the way the OFTO business is run. In particular, we would welcome a purposive approach to the implementation of the Third Package in its application to OFTOs such as a materiality test by reference to the following:

1. the MW capacity of any generation assets in which the ultimate shareholder of an OFTO has a "controlling interest" – if the combined MW capacity of the ultimate shareholder's generating assets is less than [x]MW (a fixed threshold to be set by DECC) then ownership of these assets would not be relevant when certifying the OFTO regardless of the level of "control" which the ultimate shareholder exercises in respect of such assets;
2. the percentage holding that the ultimate shareholder has in any generation assets – so that a 100% shareholding in a 100MW wind farm would be assessed on the same basis as a 20% interest in a 500MW wind farm for the purposes of 1 above;
3. whether or not the asset which generates electricity exports to the national grid – assets owned by an ultimate shareholder with back-up generation facilities would not be relevant to the test (although these assets would likely not exceed the MW capacity test in 1 above in any event); and

Balfour Beatty

Capital

4. the impact that the common ownership of an OFTO and a generation asset would have on the enhancement of consumer protection, the improvement of the functioning of the energy markets and the increase of security of supply.

This final limb of the test would be designed to assess situations which fall in a "grey area" under limbs 1-3 above and would give DECC/Ofgem discretion to treat individual cases on their merits. For example, a 100% controlling interest in a point-to-point offshore transmission system and a 25.5% interest in Barking (c.1000 MW) power station (with the ability to appoint directors and exercise shareholder rights) could not prejudice any of the aims of the Third Package. In simple terms, it would never be in Balfour Beatty's interests to make the offshore transmission assets unavailable to increase demand for electricity from Barking as the two assets form a minute part of the UK's (and Europe's) electricity supply chain and demand from Barking will bear no relation to the amount of electricity exported via the offshore transmission assets.

If you would like to discuss any aspects of this Consultation response then please do not hesitate to contact [REDACTED]

Yours faithfully

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Cc: The Office of Gas and Electricity Markets

By email: [REDACTED]

and the other is the same as the one in the first part of the paper.

~~the same as the one in the first part of the paper.~~

~~the same as the one in the first part of the paper.~~

~~the same as the one in the first part of the paper.~~