SPECIAL REPORT Q&A REPRINT January 2024

M&A in the US energy sector

FW discusses M&A in the US energy sector with Clint Vince at Dentons, Christopher Gladbach at McDermott Will & Emery and Lance Brasher at Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates.

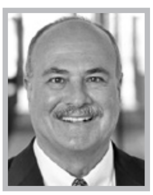
FINANCIER
WORLDWIDE corporatefinanceintelligence

Q&A:

M&A in the US energy sector

FW discusses M&A in the US energy sector with Clint Vince at Dentons, Christopher Gladbach at McDermott Will & Emery and Lance Brasher at Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates.

THE PANELLISTS



Clint Vince
Partner
Dentons US LLP
T: +1 (202) 408 8004
E: clinton.vince@dentons.com

Clint Vince is the chair of Dentons' US energy practice and co-chair of Dentons global transportation and infrastructure sector. He is rated as one of the leading energy lawyers in the US and has directed the expansion of the US energy team into a premier practice that includes professionals spanning the continent, offering a full range of services to energy industry clients. He is widely recognised for his cutting-edge theories and solutions within the energy industry and top-tier litigation track record. He is also the founder and co-chair of the groundbreaking Dentons Smart Cities & Connected Communities Think Tank.

Christopher Gladbach
Partner
McDermott Will & Emery
T: +1 (202) 756 8240
E: cgladbach@mwe.com

Christopher Gladbach is a partner at McDermott Will & Emery who counsels clients in energy mergers and acquisitions (M&A), project development, tax equity and project finance transactions. He works with energy clients in structuring complex equity and debt investments, advises both buyers and sellers in the power sector in M&A and joint ventures, and on the development of large-scale energy projects. He is recognised nationally for his client work in the energy sector.

Lance Brasher
Partner
Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates
T: +1 (202) 371 7402
E: lance.brasher@skadden.com

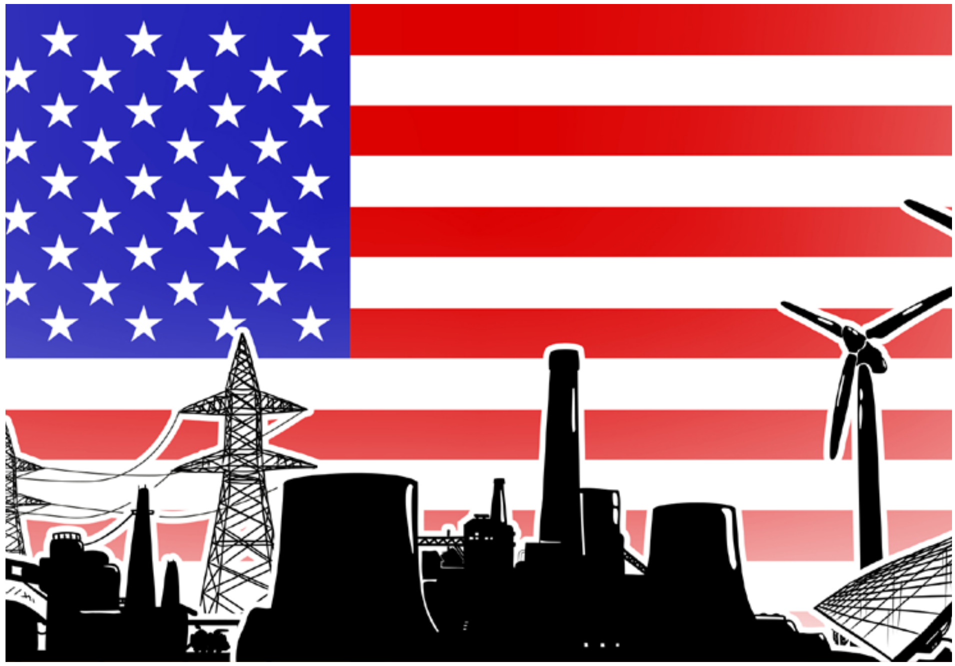
Lance Brasher is global head of Skadden's energy and infrastructure group. He is a corporate attorney concentrating in M&A, financing and development transactions involving energy and infrastructure companies and facilities in the US and around the world. Mr Brasher advises sponsors, strategic investors, private equity, pension funds, borrowers, tax equity investors, lenders and utilities in all phases of energy companies and projects.

FW: What do you consider to be among the key trends and developments currently impacting the US energy sector? How would you characterise the main challenges and opportunities in this market?

Vince: Mega trends impacting the global business sector are also having a significant impact on the US energy sector. Key among these are climate change, which is driving policy in the US at all levels, accelerated technological advances catapulted by artificial intelligence (AI), geopolitical instability causing disruption in economic systems and shifting relationships, supply chain issues ranging from physical inputs to talent pool, cyber security risks, water scarcity, which the energy sector will feel acutely, and demand-driven issues such as increasing pressures related to social equality and transparency in corporate governance. Companies operating in this environment must be both agile and resilient. While there will be short-term opportunities, companies need to focus on the long term, including all of the coming changes, in order to thrive.

Gladbach: Two corresponding trends are impacting the industry. First are the known headwinds. An increase in the cost of capital due to rising interest rates, inflation, lingering supply chain bottlenecks, and lengthy interconnection queues have changed project and platform economics. These challenges have caused a number of offtake agreements to be underwater or distressed – a trend that is even more pronounced in some offshore wind projects. Over the last year and a half, projects and platforms have been working to address all of these issues. Second, federal investment in clean energy through the US Inflation Reduction Act (IRA) is creating opportunities over the medium to long term, by expanding access to and providing certainty around tax credits. In addition, there is excitement around the energy transition subsectors, including hydrogen, renewable natural gas, domestic manufacturing and carbon capture.

Brasher: The push toward decarbonisation is having a tremendous impact on the US energy sector. Favourable laws and policies, such as the IRA, passed in August 2022, are key catalysts for investment in renewable energy, including renewable natural gas (RNG), hydrogen, carbon capture and critical minerals, attracting investment from both inside and outside the US, as well as from the largest oil & gas companies. Notwithstanding, macroeconomic issues such as higher inflation, increasing interest rates and continued supply chain disruptions, as well as development-related issues such as permitting and interconnection delays, have presented significant challenges to project development and financing, as well as M&A activity in the sector. The cancellation of offshore wind projects due to these factors has been given widespread coverage in the press.



FW: How would you describe the volume of M&A activity in the US energy sector? What factors are driving deals in today's market?

Gladbach: Except for some notable headline deals, I would characterise the volume of M&A activity in the US renewable energy sector, especially in the middle market, as fairly weak through the first three quarters of 2023, particularly in comparison to the boom in transactions across the prior three years. That said, transaction activity picked up substantially through the final quarter of the year. In addition, new market entrants represent previously untapped potential for increased activity, driven by buy-side demand. We are seeing more activity from foreign independent power producers and infrastructure funds. And private credit is booming; we are seeing sponsors increasingly tap that market, especially for development capital.

Brasher: M&A volume in the US energy sector has been muted by macroeconomic factors and valuation uncertainty, particularly for portfolios of operating and development projects. Financing liquidity has also been negatively impacted. M&A activity in the oil & gas sector has been opportunistic with the largest oil & gas companies making additional strategic US investments. Smaller oil & gas assets are being picked up through private investment, including by larger family offices. Project-specific M&A involving renewable energy assets that have mitigated macroeconomic factors and development issues, has been more robust. Also impacting investment in energy is a greater focus by infrastructure funds on digital infrastructure, in the pursuit of higher returns and the perceived attractive future of AI.

Vince: While jagged geopolitics have caused uncertainty and increased risk in investments in global markets, there have been several large, traditional mergers of note. Power sector transactions have been relatively steady, while legislation – specifically the IRA – which is directing funds toward investment in clean energy, is stimulating stronger investments in renewable projects and many other energy technologies. Lower interest rates have helped, but expectations of inflation and higher interest rates in the coming months may mean challenges for clean energy projects.

FW: In what ways have policy shifts at the federal level, such as the passage of the Biden administration's Inflation Reduction Act (IRA), impacted energy sector M&A activity?

Brasher: The US has seen the passage of two key pieces of legislation containing massive subsidy support for clean energy and decarbonisation. Firstly, the IRA, particularly with its suite of long-term clean energy tax credits amounting to hundreds of billions of dollars, is viewed as vital for clean energy project economics and is thus expected to increase valuations, and secondly, the Infrastructure Investment and Jobs Act (IIJA), particularly in its support for clean hydrogen, carbon capture and sequestration (CCS), and transmission. The IRA's transferability of clean energy tax credits will enable a much broader set of capital providers to enter clean energy. We are just beginning to see projects being financed through tax credit transfer deals and there is expected to be a massive uptick in such deals, with some closings having already taken place.

Vince: An unprecedented amount of money and tax incentives are being directed toward investment in the energy sector, and especially at projects that can contribute to decarbonisation efforts. Traditional energy companies reportedly account for over 40 percent of global emissions directly or indirectly, thus we are seeing incentives to quickly reduce this percentage and advance the greening of industrial processes through energy efficiency, electrification and fuel switching. We are seeing growth in new businesses and technologies, and energy companies have opportunities to work with regulators, lawmakers and stakeholders to implement policies that support reducing carbon emissions and quicken the deployment of new, cleaner technologies, allowing them to adapt business models to an electrified future. Consumers also benefit from the law, which will drive shifts in demand. Funding from the IRA is still in its early stages, and the fate of the legislation is uncertain as the US heads into an election cycle where Biden administration opponents have pledged to repeal the climate law.

Gladbach: Because of the IRA, the industry will, in the medium to long run, overcome the macroeconomic factors that slowed M&A activity in 2023. The IRA, enacted in August 2022, represents the federal government's largest ever investment in clean energy. In addition, the transferability provisions of the IRA allowing parties to sell tax credits to third parties, mostly large corporate entities, has provided a significant source of new capital. We foresee the transferability market fulfilling a large part of the energy transition capital requirements. Adding fuel to the fire is the IIJA. Passed nearly a year before the IRA, the IIJA is directing additional billions into energy transition technologies, including hydrogen and carbon management.

FW: Could you highlight any recent, significant energy deals which caught your attention? What particular aspects made them notable?

Vince: The standout energy mergers of 2023 are ExxonMobil's $60bn acquisition of Pioneer Natural Resources and Chevron's $53bn acquisition of Hess Corporation. These mergers strengthen each company's respective resource base in the US and are significant because, despite enormous competition globally for capital, the majors are still choosing to invest in the US. Also noteworthy were TotalEnergies' acquisition of several assets in Texas, and its joint projects to develop renewables along the east coast of the US, even as offshore wind has slowed significantly.

Gladbach: A few recent deals give support to the trends that we are seeing. For example, community solar seems to be white-hot. Community solar is an exciting space. The margins on these projects are very high, and they are a relative bright spot in the solar market. Another key trend is build-transfer agreements (BTAs). The low cost of renewables projects, compared with the price tag of retrofitting ageing coal fleets or building new natural gas facilities, has made renewables an attractive option economically for utilities.

Brasher: The strategic investments by the largest oil & gas companies in the US oil & gas sector have been remarkable, although it is unclear whether these transactions represent a trend that will continue. In the renewable energy and decarbonisation space, the emergence of tax credit transfer deals enabled by the IRA will be the first of many to come and can be expected to transform the financing of clean energy tax credits. Already, a robust market of brokers and buyers of tax credits is developing. However, sellers of tax credits will need to consider the associated discounts and transaction costs, including that of banking

"THE STRATEGIC INVESTMENTS BY THE LARGEST OIL & GAS COMPANIES IN THE US OIL & GAS SECTOR HAVE BEEN REMARKABLE, ALTHOUGH IT IS UNCLEAR WHETHER THESE TRANSACTIONS REPRESENT A TREND THAT WILL CONTINUE."

LANCE BRASHER
Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

and broker intermediaries, that will be needed to complete the sale.

FW: What general advice would you give to parties on negotiating, structuring, financing and closing deals in the US energy market? What key areas need to be considered?

Gladbach: Buyers of renewable energy projects must focus on diligence and the downside case. Are all the project risks allocated effectively? Buyers need to make sure that all critical project elements, offtake, site control, interconnection, project documents, energy regulatory matters and tax matters are effectively understood and addressed. If a project or platform does not perform as expected, what are the consequences? For minority-stake deals, governance is of course critical.

Brasher: Where possible, sponsors should structure revenue contracts to allow for a passthrough of inflation, particularly for greenfield projects. After over a decade of stable or declining costs and reliable increases in productivity and efficiency, many development projects which priced offtake based on those circumstances have been hit hard by higher inflation and interest rates in recent times, and key projects have been forced to restructure or have been cancelled. Developers and investors must do their due diligence for supply chain vulnerabilities and develop supply chain alternatives where possible. Numerous projects have been delayed or forced to source project components at higher costs to avoid supply chain issues. In addition to legal compliance, political and tariff risks have posed significant issues. Where relying on the domestic content benefits attached to the clean energy tax credits, sponsors should examine the potential supply chain for compliance and secure supporting contractual arrangements. Given the challenges associated with financing liquidity, sponsors should consider federal funding opportunities. The US Department of Energy's (DOE) Loan Programs Office (LPO) has more than $400bn in loan and loan guarantee authority to support clean energy, carbon dioxide transportation infrastructure, and energy infrastructure investment. For semiconductor manufacturing, the US Department of Commerce's CHIPS Program Office offers up to $39bn in incentives.

Vince: Patience and flexibility are key. Opportunities for investment are plentiful, and the need for infrastructure is great. However, investors need to be prepared for delays. On the power side, permitting, siting, transmission development and long interconnection queues are serious challenges that will cause some investment to shift to distributed energy resources. Even with the huge opportunity for financing coming into the markets because of federal legislation, some highly promising technologies will continue to face pricing and commercial obstacles. There is also continued demand for fossil fuels, particularly natural gas. The US has become a major exporter of oil and natural gas, even as the US government signed on last year to the Intergovernmental Panel on Climate Change (IPCC) joint declaration of importers and exporters to reduce emissions from fossil fuels, and external pressures continue to grow. 2023 was the hottest year on record and this will no doubt influence future deals and shift expectations going forward.

> BUYERS OF RENEWABLE ENERGY PROJECTS MUST FOCUS ON DILIGENCE AND THE DOWNSIDE CASE. ARE ALL THE PROJECT RISKS ALLOCATED EFFECTIVELY?
>
> CHRISTOPHER GLADBACH
> McDermott Will & Emery

FW: Could you highlight some of the risk-related issues that need to be addressed when undertaking a transaction in the US energy sector? How can acquirers manage those risks to enhance future value?

Brasher: Close diligence must be given as to how operating and development platforms and assets address key risks that are having a substantial impact – inflation, interest rates, supply chain, interconnection and other development issues – and the extent to which sponsors, operators and developers have been able to allocate those risks away to creditworthy project counterparties. These are fundamental principles of project financing, and it is, historically, the well-structured projects from a project financing perspective that are the most sustainable. In M&A purchase and sale agreements, in recent years, buyers and sellers have come to rely heavily on representation and warranty insurance (RWI). RWI has had a significant impact on accelerating transaction negotiation and execution, however RWI may not be as effective in addressing development-related and hard-to-diligence issues. Accordingly, we have seen more complex purchase price adjustments and earn-out structures to address risks and fill valuation gaps between buyers and sellers.

Vince: Inflation and interest rate risks and supply chain risks remain front and centre in board discussions, along with regulatory risk going into a heated election year. Also, critical but underdiscussed, labour force will be a significant challenge with the widescale retirements of the baby boomer generation, taking with them decades of institutional knowledge. Technologies like AI will help fill the gap but will not solve the problem in the near term. Companies will need to be creative in order to manage supply risks and will need to be flexible to contend with regulatory delays. Given the current state of environmental litigation, with non-governmental organisations (NGOs) and residents in adjacent communities challenging projects, companies need to consider engagement with stakeholders early and at all stages of projects. Company leaders should not underestimate the impact of social demands and should consider looking for ways to partner with the communities that are impacted. Additionally, cost considerations, even with unprecedented government investment, will be challenging. The need for investment in energy infrastructure in the US is huge, which means huge opportunities, but also tremendous challenges. High energy prices are attractive to investors but will cause both shifts in demand and scrutiny from regulators.

Gladbach: Delays and cost overruns at the project level due to supply chain constraints, interconnection delays, inflation and a tight labour market continue to add risk for those undertaking a development-stage transaction in the US renewable energy sector. Some of those risks, like the supply chain risk, appear to have been mitigated recently with the boom in onshoring manufacturing. Acquirers can insist that price adders, tailored purchase price earn outs, and other contractual mechanisms are in place to allocate some of these risks between the parties, especially when several development milestones have yet to be achieved. Focused due diligence is always important.

FW: How do you expect energy sector M&A in the US to unfold over the months and years ahead? To what extent is future activity likely to be driven by energy companies' transformation and reinvention objectives?

Gladbach: I expect activity to pick up significantly in the short term, and for the industry's progress to be bright. This view is largely shared by investors in the space despite recent challenges. I also think the transferability of tax credits will add more flexibility for project sponsors. Regulated utilities will continue to be strong buyers of renewable projects through BTAs, which see the utility contract with a developer to build a project that the utility purchases upon its completion. Further, large corporates remain committed to the sector, and we still see a lot of activity in the corporate and industrial offtake market.

Brasher: Despite current macroeconomic headwinds, there is strong momentum to decarbonise and pursue the clean energy transition in the US. On top of the compelling benefits and funding available under the IIJA and the IRA, other regulatory tailwinds include proposed climate-related regulations by the Environmental Protection Agency (EPA) and the Securities and Exchange Commission (SEC). There is political, legislative and regulatory uncertainty, however, with the 2024 presidential election looming and the potential for a shift in power in both the executive and legislative branches. Demand for renewables is expected to remain strong and there are many energy transition funds yet to come. Should inflation continue to moderate and interest rates stabilise, there is a tremendous amount of both public and private capital still to be deployed that could lead to a robust rebound in M&A activity in the energy sector as a whole.

Vince: At present, there is an expectation that the Federal Reserve will raise interest rates, which will have a dampening effect on activity, as will inflation. Supply chain issues will continue to pose stumbling blocks. Most expect to see continued upstream M&A activity involving smaller and medium-sized oil & gas producers in Texas and the Permian Basin. Liquified natural gas (LNG) sales to Europe and beyond are increasing. Many industry observers appear optimistic about new renewable projects fuelled by IRA support, but here, too, high inflation, supply chain bottlenecks and regulatory delay relating to licensing, siting of projects, ratemaking, and so on, will certainly hinder project development. In November 2023, Utah Associated Municipal Power System (UAMPS) and NuScale Power called off their small modular reactor project, citing rising costs, supply issues and insufficient subscriptions. Offshore wind is also slowing due to costs and regulatory hurdles. Ørsted recently terminated two of eight projects along the east coast. On the positive side, there has been an uptick in activity investment activity in hydrogen hubs spurred by IRA funding. ■

> INFLATION AND INTEREST RATE RISKS AND SUPPLY CHAIN RISKS REMAIN FRONT AND CENTRE IN BOARD DISCUSSIONS, ALONG WITH REGULATORY RISK GOING INTO A HEATED ELECTION YEAR.
>
> CLINT VINCE
> Dentons US LLP