



■ SPECIAL REPORT Q&A REPRINT January 2023

Energy transition: the role of traditional energy

FW discusses the role of traditional energy in the energy transition with Jennifer Morrissey at Dentons and Hywel Davies at Slaughter and May.



Q&A:

Energy transition: the role of traditional energy

FW discusses the role of traditional energy in the energy transition with Jennifer Morrissey at Dentons and Hywel Davies at Slaughter and May.

THE PANELLISTS



Jennifer Morrissey
Counsel
Dentons
T: +1 (202) 408 9112
E: jennifer.morrissey@dentons.com

Jennifer Morrissey, a member of Dentons' energy practice, divides her practice between traditional regulatory and transactional matters relating to energy, resources and infrastructure, and federal litigation and appellate work related to energy and resources. Her clients include asset managers, private equity firms and investors, banks and financial institutions, trade associations and ad hoc coalitions, foreign corporations, municipal entities and rural electric cooperatives, natural gas producers, public utilities, cogeneration facilities, project developers, state utility regulators, federal hydropower customers and large industrials.



Hywel Davies
Partner
Slaughter and May
T: +44 (0)20 7090 3102
E: hywel.davies@slaughterandmay.com

Hywel Davies is co-head of the global infrastructure, energy and natural resources practice at Slaughter and May. He has particular experience in public and private M&A and joint ventures in these sectors, as well as providing strategic and governance advice in relation to energy transition and other energy sector matters.

FW: How would you characterise the world's current dependence on fossil-based systems of energy production and consumption?

Morrissey: The world is still heavily dependent on fossil fuel systems, particularly in certain regions, and we are so far behind on addressing climate change that dramatic action will need to be taken. The challenge is that such action cannot occur abruptly. We will need a transition strategy that can be particularised to variations in regions and development status. The process will be politically and economically fraught and will require a lot of negotiations and sacrifice. It also will require greater support of developing countries by developed countries that have done most of the polluting and whose economies benefitted from that polluting, a situation that has just been recognised at COP27.

Davies: While decarbonisation has, understandably, been the main focus of energy policy for a number of years, in the last year, particularly in Europe, we have seen the resurgence of the energy trilemma: the balance between ensuring security of supply, decarbonisation and affordability of our energy sources. In particular, energy security has risen up the political agenda; interlocking crises have highlighted vulnerabilities in our global energy system's capacity to sufficiently harness, convert and distribute energy to consumers. Simultaneously, tackling energy poverty remains a persistent critical priority. An unacceptably vast number of people – around 775 million people worldwide – still live without access to electricity. This represents 20 million more than a year ago. There are also vast differences in countries' energy consumption levels. For instance, The Economist reports that an American family's refrigerator consumes more energy per year than a typical African person. At the same time, reversing the trend in global emissions is the 21st century's most important moral and economic challenge. Tackling these conjoined concerns compels us to remake industries on which people still rely, and which still lie at the heart



of the global economy. In the UK, energy security concerns have instigated a range of short-term measures which risk increasing our greenhouse gas emissions.

FW: How would you gauge the current penetration of renewable energy into the energy supply mix?

Davies: There is significant deployment globally but still much more to do. The International Renewable Energy Agency reports that at the end of 2021, there was 3064 GW of global renewable generation capacity: hydropower, solar and wind generation make up around 95 percent of this. Importantly, the renewable share of total generation capacity rose by almost 2 percent, from 36.6 percent in 2020 to 38.3 percent in 2021. This means renewables are meeting a greater proportion of demand globally, which is crucial for the energy transition. However, progress is not uniform. For example, the share of renewable energy across the African continent remains around 9 percent, an incredibly low figure given the region's renewable resources. Rapid declines in wind and solar generation costs are driving increased deployment in renewables. For

example, in the UK, average prices for generating offshore wind power have now fallen to around £37 per megawatt hour in the latest contract for difference allocation round. These prices are almost 70 percent less than that secured in the first allocation round, in 2015. It remains to be seen, however, whether cost reductions can be sustained during the current period of high inflation.

Morrissey: Current levels of penetration of renewable energy technologies are increasing, but it is still relatively low in most regions. Renewables will need to double or triple within the next decade or two if we are to make any significant progress toward climate goals. Both the transition and increased penetration will create stress on existing infrastructure. The hope is that long-duration energy storage and advances in distributed energy technologies will help, although we are not yet where we need to be. On the demand side, much greater emphasis on energy efficiency and conservation is needed as these, too, are essential elements for both energy supply and climate strategies.

FW: How committed are governments to the process of decarbonisation? What have been the latest legal and regulatory developments affecting traditional energy companies on this front?

Morrissey: The commitment of governments has been quite mixed. Implementation of decarbonisation strategies has frequently fallen short of stated commitments, whether because of political or economic concerns or a lack of a sense of urgency. The slowness of governments to effectuate decarbonisation has prompted the environmental, social and governance (ESG) movement across industry sectors, initially to prompt socially responsible investing, but increasingly with broader application. In the US, there has been tension between the goals of the Biden administration and the views of a number of Republican states such as Texas and Florida; nevertheless, the US has recently passed three major pieces of legislation that will dramatically advance decarbonisation: the Infrastructure Investment and Jobs Act, the Inflation Reduction Act, and the CHIPS and Science Act.

Davies: Governments appear committed to this agenda, at least in the long-term. Policy and technology changes, notably since the 2015 Paris Agreement, have already reduced projected global

temperature rises. But, as we heard recently at COP27, more is needed in respect of implementation. Independent assessments – such as those from the Intergovernmental Panel on Climate Change (IPCC) and the United Nations Environment Programme (UNEP) – show that more interventionist government action is needed to stabilise temperatures at 1.5 degrees Celsius. Intrinsically, governments face the problem of reducing humanity’s reliance on fossil fuels by deploying emerging technologies requiring large-scale investments, here and now, with benefits only being seen in the long term. These decisions are particularly difficult for policymakers and politicians, who typically prioritise policies with more visible, immediate and local benefits. Decarbonisation goals should permeate into all areas of policy. For example, I fear our response to the present energy crisis might be a missed opportunity. Keeping energy prices artificially low is not always an optimal policy approach. In limiting energy prices, government measures to date have typically overlooked two issues: the capacity of some companies and individuals to absorb higher prices, and countries’ existing demand-side dependencies.

FW: In terms of driving the global energy sector’s transition toward renewable energy sources, how important are growing stakeholder demands for

environmental, social and governance (ESG) performance?

Davies: ESG performance is becoming ever-more important. Companies are increasingly engaging with a range of stakeholders on ESG-related matters. We are also seeing a raft of voluntary initiatives and regulatory changes, particularly to promote ESG disclosure and due diligence of supply chains. To focus on one key stakeholder group, we are seeing increasing pressure from company shareholders. Some ‘activist’ shareholders seek to use the ESG agenda to pursue company reforms to increase shareholder value. However, ESG activism is a broad church: its followers do not always speak with a unified voice. Indeed, activists commonly advocate for different strategies in the name of ESG and the energy transition. We see this manifesting in several ways. Some call for existing publicly listed oil and gas companies to serve as responsible stewards for the energy transition. Others are calling for an immediate cessation of oil and gas production and advocate asset disposals. Lenders are also under increasing pressure to constrain the availability of finance for traditional energy projects or heavily-weighted carbon portfolios.

Morrissey: ESG was initiated by investors interested in greater sustainability and focus on risks not traditionally considered when evaluating shareholder value. The rapid pace of the adoption of ESG policies is an indication of its importance to stakeholders, who are stepping up where governments have lagged. The ESG movement has evolved to include customers and communities impacted by businesses, and has expanded beyond pure investor interest to non-investor governmental and other organisations in civil society. In the US, the issue has become politically fraught in some locations. Nineteen state attorneys general are participating in an investigation into biases underlying certain ESG initiatives and some states have passed laws blocking initiatives, particularly where ESG considerations result in capital being directed away from the fossil fuel industry.

“
IN THE LAST YEAR, PARTICULARLY IN EUROPE, WE HAVE SEEN
THE RESURGENCE OF THE ENERGY TRILEMMA: THE BALANCE
BETWEEN ENSURING SECURITY OF SUPPLY, DECARBONISATION
AND AFFORDABILITY OF OUR ENERGY SOURCES.
”

HWEL DAVIES
Slaughter and May

FW: In your opinion, what role do traditional energy companies have to play in the energy transition and achieving climate goals? What key challenges do they face along this journey?

Morrissey: Traditional energy companies continue to have a vital role to play in the energy transition and in addressing climate change, although the degree to which they are willingly participating varies. For example, some traditional companies in Europe have dramatically invested in renewables as well as demand side opportunities, which has created a lot of revenue and jobs. Traditional energy companies often have the advantage of scale to implement new technologies in an impactful manner. Much like the transformation of the telecommunications sector a couple of decades ago, where companies that rode the wave of change thrived far more than those that paddled against it, companies that embrace the energy transition and actively seek new roles in the shifting infrastructure paradigm are likely to be far more successful in the long run than those that resist change.

Davies: Traditional energy companies have a critical role in the energy transition. They have the technical and operational capacity, as well as the capital, needed to drive the energy transition. However, traditional energy companies face challenges in investing in transition projects, particularly development projects that do not generate immediate returns. Many companies need to use revenues from their legacy energy assets to fund long-term investments in emerging technologies. New projects often have long lead times and can require changes to the regulatory framework, which presents challenges for companies seeking to reduce their exposure to carbon-intensive operations. Another challenge is that political timeframes for the energy transition are now moving ahead of what is practically achievable. Synchronising the scale-up of emerging technologies with the retirement of traditional energy assets is a complex exercise, even for the most sophisticated companies.

“RENEWABLES WILL NEED TO DOUBLE OR TRIPLE WITHIN THE NEXT DECADE OR TWO IF WE ARE TO MAKE ANY SIGNIFICANT PROGRESS TOWARD CLIMATE GOALS.”

JENNIFER MORRISSEY
Dentons

FW: What practical steps are traditional energy companies taking to reduce carbon emissions from their current operations and diversify their energy sources? How would you rate their progress?

Davies: Companies are at different stages in their decarbonisation journeys. However, many are deploying similar strategies to take advantage of energy transition opportunities. These include portfolio management and industry consolidation: many companies are using strategic M&A to decarbonise existing operations by acquiring ESG assets or repurposing existing assets. Other deals have involved investments in greener feedstock production processes, such as low-carbon hydrogen or product supply chains. Concurrently, CCUS, hydrogen and carbon removal technologies are gaining momentum, with a growing pipeline of new projects, many of which are being led by traditional energy companies. New business models aimed at improving the financial viability of these technologies, combined with the high prices of oil and gas, are accelerating this transition.

Morrissey: Several reports indicate that traditional energy companies account for over 40 percent of global emissions either directly or indirectly. There are several tools available to quickly reduce this percentage and advance the greening of processes,

including energy efficiency, electrification and fuel switching, along with carbon capture and use and storage, and detecting, reducing or recovering vapour leaks. Companies can also invest in carbon offsets, such as planting trees. Companies can also work with regulators, lawmakers and stakeholders to implement policies that support reducing carbon emissions and quicken the deployment of new, cleaner technologies.

FW: What essential advice would you offer to traditional energy companies on taking advantage of current and future opportunities as the world shifts from fossil-based energy production and consumption to renewable energy sources?

Morrissey: In the US, the traditional energy companies should take advantage of the three pieces of legislation that are directing an unprecedented amount of money and tax incentives toward decarbonisation. Company executives should be thinking about their company's impact on the future of their children and grandchildren in addition to the legitimate job of protecting value for shareholders today. By doing so, they can achieve an optimal solution that brings value to all stakeholders. Every day, there are media reports predicting an explosion in the climate economy. This represents a tremendous opportunity for companies to

thrive while making proactive, intentional adaptations rather than simply reacting or struggling to maintain an unsustainable status quo.

Davies: Opportunities are rampant in this fast-developing and dynamic environment. A firm grasp of market fundamentals, geopolitics and regulatory factors will help corporate decision makers better harness these opportunities. For example, regulatory reforms in the UK energy supply market may drive further consolidations if the costs of compliance with those regulations make scale and financial capability more critical. Partnerships and risk-sharing arrangements will probably become more commonplace. Comparing

different jurisdictions' investment climates and regulatory regimes will also enable companies to shift investment to where the returns are most significant. As new technologies begin to prove themselves and mature, a greater role for private equity and private capital investments in energy transition investment and M&A is likely. Opportunities also exist for companies to assist governments in developing regulatory regimes in ways that de-risk private investment and unlock exponentially larger flows of energy transition finance. Our experience of governments' responses to the energy crisis indicates their willingness to listen. Fundamentally, durable energy transition policies must secure support from actors across the political spectrum,

business leaders and civil society. Such transition policies must also unfold in socially 'just' ways, ensuring no one is left behind. ■

This article first appeared in the January 2023 issue of Financier Worldwide magazine. Permission to use this reprint has been granted by the publisher. © 2023 Financier Worldwide Limited.

FINANCIER
WORLDWIDE corporatefinanceintelligence