CRA Charles River Associates

The opinions expressed are the author's and do not reflect the views of the firm or any of its respective affiliates.

Published by Financier Worldwide Ltd
©2019 Financier Worldwide Ltd. All rights reserved.

Permission to use this reprint has been granted by the publisher.

ROUNDTABLE July 2019

CONSOLIDATION IN THE UK ENERGY MARKET

The UK energy market is undergoing major change, with regulatory headwinds, soaring costs, increasing competition, new technologies, supply and storage issues and a growth in renewable consumption shaping activity. Also a key factor is the market's drive toward consolidation, a trend signalled by a significant number of mergers, acquisitions and exits. In order for the sector to prosper, suppliers across all energy generation types need to focus on the sustainability of their business models and the robustness of their systems, controls and service standards. ■

THE PANELLISTS

James Knight
Partner, Augusta & Co.
T: +44 (0)20 7776 0800
E: info@augustaco.com
www.augustaco.com

James Knight co-leads Augusta's renewable energy practice. Since joining the company in 2003, he has been dedicated to the sector, working across the spectrum of clean energy technologies. He has worked on the company's first renewables transactions and led some of Augusta's largest and most complex transactions with some of the industry's leading players, including Vattenfall, RWE, GE Capital, ERG, PNE Wind AG, DIF, Riverstone Capital, NIBC Infrastructure and Platina Partners.

Colin Johnson
Vice President, Charles River Associates
T: +44 (0)20 7959 1548
E: colinjohnson@crai.com
www.crai.com

Colin Johnson is a vice president in Charles River Associates' energy practice. He has more than 25 years of experience in the energy and infrastructure sector with a particular focus in the power, oil and gas industries. Mr Johnson has international experience in analysing, negotiating and managing major energy projects and has worked in Europe, North America, Latin America, Africa, the Middle East and Asia.

Chris Staples
Partner, Linklaters LLP
T: +44 (0)20 7456 4876
E: chris.staples@linklaters.com
www.linklaters.com

Chris Staples is a corporate partner in Linklater's energy, natural resources and infrastructure practice, a sector leader for energy & utilities and co-head of the firm's global commodities group. He regularly advises leading corporates and banks, as well as funds and governments, on energy and commodity market-driven investments, covering a broad range of sector-specific challenges and transactions.

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

Hywel Davies is co-head of Slaughter and May's global Infrastructure and Energy practice. He advises corporate clients and private equity and infrastructure funds on a wide range of transactions and issues in the sector. He has particular expertise in public M&A, joint ventures and large portfolio deals, and has advised on over $100bn of oil and gas, power and renewables transactions in the last five years.

FW: How would you describe the state of the UK energy sector over the last 12-18 months? What factors are shaping the industry?

Knight: This year, we have seen records broken for the longest period of continuous generation without coal and had periods in which renewable energy generation exceeded overall demand. Growing renewable penetration is also stimulating flexible battery storage to help intermittency and grid balancing. Coal dependency is falling, with plants adopting co-firing strategies with biomass. The government has supported new nuclear plants. Construction has started at the Hinckley Point power station, despite the stalling of the planned Wylfa plant. However, support for renewable energy has largely evaporated, stopping new builds until recently as the market adjusts to investors managing the variability of long-term power pricing without subsidy support. In addition, the UK's capacity market scheme has been suspended following a European Union (EU) ruling on 15 November. The extent to which this will change power markets is uncertain, but revised market guidelines in light of this may be expected to offer longer demand-side response contracts and give greater preference to low-carbon generators.

Johnson: Flux and uncertainty are key issues affecting the UK energy sector today. Will Labour win an election and will it nationalise energy networks? Will Brexit happen and if so will the Irish Single Electricity Market continue and will the UK remain part of the internal energy market? Will the renewable energy sector pick up again after new investments dropped by nearly a third? Will an increase in investment in the North Sea continue? What is shaping the industry is a mix of changes in technology and cost, particularly for renewables and energy storage, the drive to cleaner energy and some UK politics around Brexit, but also around utilities not being in favour with government and a regulator keen to show pro-consumer credentials.

Staples: It is a period of dynamic change across the UK energy sector. Regulatory pressures on the energy supply sector have, particularly since the price cap, stressed the business models of suppliers that have, in response, looked to diversify their offering to customers and use strategic transactions to remove cost. The North Sea has continued the trend of exiting major oil companies, with private equity (PE) money coming in to replace them. New development opportunities in the North Sea continue to make the basin an interesting long-term play for some, including some of the remaining majors. We are seeing continued deployment at scale of renewables, and in particular offshore wind, as the low-carbon technology of choice continues the trend of energy transition away from carbon-intensive sources. Nuclear still struggles with the scale of investment required and the complexity of deployment to be competitive with other solutions.

Davies: The mood in the North Sea is more positive, with higher oil prices of late. Increased confidence has brought more investment in new projects and more M&A as the value gap between buyers and sellers has narrowed. The oil & gas regulator, the Oil and Gas Authority (OGA), is focused on maintaining or increasing investment and production and maximising economic recovery (MER). The nascent onshore shale gas industry has stalled and there appears to be little prospect of it gaining the political support it needs to move forward in the short to medium term. In the power and renewables space, a combination of factors, including regulatory headwinds and increased competition from new and recent market entrants, has created a challenging environment for the traditional power utilities. However, a significant number of new 'challengers' in the supply market have failed over the last 18 months, and concerns about the sustainability of their business models and the robustness of their systems, controls and service standards continue to plague a number of others, leading the Office of Gas and Electricity Markets (Ofgem), to take steps to ensure customers are adequately protected.

FW: Have any recent M&A deals in this space caught your eye? What are the key factors driving consolidation?

Johnson: A couple of deals and a non-deal have caught my eye. The first is the acquisition last year by BP of the Chargemaster network, the UK's largest electric vehicle (EV) charging company, which runs the Polar network of 7000 charging points. It reflects how EV is encroaching on the traditional market of fuel suppliers and as part of its plans for Chargemaster, BP wants to install charging points to deliver 100 miles range with 10 minutes of charging. The second deal driving consolidation is the £1.6bn purchase of Chevron's North Sea business by Ithaca Energy, part of a trend which has seen ConocoPhillips, Marathon and Nexen all divesting North Sea assets in what is a changing of the guard in terms of investors. Finally the non-deal, the SSE npower deal that did not happen, shows how fast the economics of the supply sector have changed, particularly with a regulatory price cap in place.

Staples: Chrysaor's acquisition of ConocoPhilips' North Sea interests is notable for the increasing role of PE in asset ownership. We expect that trend to continue. The scale of UK wind assets has pulled in pension funds and other infrastructure investors to developed UK assets, which shows that the attraction of the UK power sector to foreign investors is still strong. That said, the risk of nationalisation of transmission infrastructure under a Labour government is inevitably going to affect that particular market segment.

Davies: There have been a significant number of large portfolio deals and strategic joint ventures in the oil & gas space over last 12-18 months. Key drivers have included majors and large independents retreating from the North Sea to focus on less mature or higher growth assets elsewhere, attracting

interest from financial sponsors and smaller independents. Also, large corporates for whom oil & gas has not been their core business have turned to joint ventures to dilute their investment in exploration & production (E&P) while trying to increase the scale of the underlying businesses. Infrastructure funds have been active in midstream deals, with pipelines and floating production storage and offloading (FPSOs) of particular interest.

Knight: The market sees a diversification of appetite and investment rationales. However, the onshore and offshore markets have been consolidating, to a degree, under certain thematic investment strategies. Onshore wind and solar markets have been attractive to yieldcos and passive infrastructure funds, attracted to the non-correlated government supported returns available. In the meantime, offshore wind has been drawing in international players with an interest in global offshore wind technology transfer. As offshore starts to move outside of Europe, international companies are looking to get to grips with the sector in well-established markets such as the UK. The most significant deal of this nature would be the acquisition of a majority stake in the 857MW Triton Knoll Wind Farm by Japanese firm J-Power. Some large strategic players have also entered the market, such as Sembcorp, BP, Shell, Tenaga and Vitol, to establish positions often in the development stage to improve returns or export skills to their global markets.

FW: What advice would you give to acquirers in terms of identifying energy targets with attractive prospects in today's market?

Staples: Acquirers need to get the right advice on regulatory structures. Energy is a global business dominated by local issues, so you need advisers that understand the local markets and are not just flying in.

Knight: In the absence of subsidies, investors need to have fully thought through the implication of merchant power risk, or the availability of a suitable hedge through commercial power purchase agreements (PPAs). Some players look to mitigate this through a more active management strategy, to drive value from technical performance as well as energy trading. The most effective investment managers have proactive technical skills. Managers can also extract better performances from larger portfolios. This extends beyond managing costs at an aggregate level, to adopting more sophisticated energy hedging strategies across multiple assets.

Davies: Oil & gas assets generating stable production at relatively low cost are the safest bet, particularly for those concerned about further oil price volatility. Targets that offer cost or tax synergies can be particularly attractive. Sellers motivated primarily by strategic rather than purely financial considerations may have more flexibility on price or consideration structures, allowing buyers to secure attractive terms while satisfying the sellers' strategic objectives.

Johnson: Today, perhaps more than ever, acquirers need to consider how technology, changes in the competitive landscape and political issues could affect the direction of the sector as a whole. For an acquirer, it is worth considering how a target would perform under a variety of scenarios, particularly considering differences in electricity storage and possibly in regulation going forward. The growth of electric vehicles also impacts traditional oil & gas markets.

FW: Are there any recurring themes in the way transactions are being structured and financed?

Davies: The larger portfolio deals and strategic joint ventures have generally been structured as corporate share sale transactions in the oil & gas space. A number of deals have seen deferred or contingent elements of consideration. That reduces the upfront cost for buyers and allows them to fund part of the purchase price later out of future cash flows from the target business. Sellers have also had to take a pragmatic

SELLERS MOTIVATED PRIMARILY BY STRATEGIC RATHER THAN PURELY FINANCIAL CONSIDERATIONS MAY HAVE MORE FLEXIBILITY ON PRICE OR CONSIDERATION STRUCTURES.

HYWEL DAVIES
Slaughter and May

approach to decommissioning liability and decommissioning security arrangements – a number of sellers have agreed to share some future decommissioning costs associated with the assets being sold or to continue to 'front' decommissioning security.

Johnson: Two substantial lenders into the UK energy market are either changing focus or are being potentially impacted by Brexit. The Green Investment Bank, now sold off and part of the Green Investment Group of Macquarie, has been viewed by some in the industry as moving away from a UK focus. Similarly, the European Investment Bank (EIB), historically a substantial lender, has seen activity curtailed by Brexit uncertainty. In light of this, the committee reviewing the EIB's activity recommended in March 2019 that the UK set up a new infrastructure bank. The government is yet to respond to that.

Knight: There are no clear trends; transactions are very specific to the buyer and the risks involved. The steady diversification of interest and strategies from a range of parties, such as investment funds, corporates, PE, yieldcos and so on, means that there are, essentially, no recurring themes in the way transactions are structured and financed.

Staples: On the sell-side, we continue to see the auction process as an effective mechanism to drive the best terms for sellers. On the buy-side, I would say the most important thing is still price, followed by certainty. While recognising that the auction process makes negotiation of better terms difficult, buyers should not be afraid to ask for a sensible risk allocation. We are also increasingly seeing warranty and indemnity (W&I) insurance being used by buyers to support a reasonable set of business warranties.

FW: What specific due diligence and transactional risk management challenges exist in the energy sector, which acquirers need to address?

> ENERGY IS A GLOBAL BUSINESS DOMINATED BY LOCAL ISSUES, SO YOU NEED ADVISERS THAT UNDERSTAND THE LOCAL MARKETS AND ARE NOT JUST FLYING IN.
>
> CHRIS STAPLES
> Linklaters LLP

Johnson: One of the keys is considering the resilience of cash flows in a variety of scenarios and carrying out the scenario analysis on that basis. Swanson's law is that solar voltaic module costs drop 20 percent for each doubling of cumulative shipped volume. We have not yet seen the equivalent law for storage but the reality is that storage costs are already dropping rapidly. A system with substantial storage could impact revenue flows across the power sector, so changes to the system need to be evaluated carefully. Equally, the basis of costs, such as capacity charges, may change, given the fact that companies increasingly have 'behind the meter' generation and storage which has an impact on maximum demand, typically used as part of cost setting.

Knight: In general, purchasing energy assets involves capital-intensive, long-term investments. As a result, acquirers need a sophisticated understanding of energy resource and power price exposure. On the revenue side, this means managing power price exposure, inflation risks and long-term resource forecasts, particularly in light of degradation, capture prices and curtailment risks. With regard to costs, project life extensions are fundamental to value. This means proactive maintenance, taking advantage of new advances in predictive maintenance and data collection.

Staples: Due diligence and risk management entirely depends on the asset class, but we typically find that buyers new to the North Sea decommissioning regime are often unaware of the risk of decommissioning liability bypassing the normal limited liability company structures and passing up the chain to parent companies. This is a very technical area that requires careful consideration at an early stage.

Davies: There are a number of legal issues that most buyers will focus on, including third-party consent and change of control issues. For renewables transactions, especially wind, key areas of focus will be construction contracts, including liability periods and liquidated damages regimes, operation and maintenance arrangements, offtake arrangements, subsidy regimes, grid

connection arrangements, property rights and direct agreements. For transactions on the supply side, there will be more focus on the integrity of systems and controls.

FW: Are any legal and regulatory issues having a notable impact, either directly or indirectly, on M&A in this space?

Davies: The exposure that UK Continental Shelf (UKCS) licence holders, former licence holders and their associated companies have to decommissioning liabilities under the Petroleum Act continues to have a significant impact on transaction structuring and terms. With the buyer universe increasingly made up of smaller independents and PE-backed companies and more mature assets being sold, sellers have had to accept that they will bear a share of the cost of decommissioning the assets they are selling and retain greater exposure to the risk that future decommissioning liabilities come back to haunt them after they have sold out. This is driving some creative structuring of consideration and payment flows between buyers and sellers, new approaches to decommissioning security, and some careful structuring by financial sponsors and other investors to try to reduce the risk that other entities in their structure become 'contaminated' with exposure to decommissioning liability.

Staples: The increasing trend for buyers to take out W&I insurance to cover business warranties is probably the most notable market trend.

Knight: The biggest impact on renewable energy M&A comes from the loss of subsidies. Project profitability is now primarily dependent on power prices relative to generation, subject to any hedges in place. Alongside this, the changing value of carbon credits adds another consideration to balance sheets. Carbon costs have risen sharply in recent months, and this can provide a boost or a blow to power producers. For existing projects or development pipelines, it is also important to consider the likelihood of planning extensions. The UK has seen several renewable energy projects rejected on planning grounds over the past few months. With increased levels of local opposition to renewable energy developments, particularly wind, acquirers need to bear in mind the risk that projects may not meet local planning criteria. Finally, it is vitally important to understand the way that Ofgem's Targeted Charging Review is headed. This programme is designed to fairly balance costs within power networks, to create a more efficient system. While there are no final findings, this may result in large costs for many renewable energy generators.

Johnson: Various issues, such as the price cap suggested by Ofgem, the potential impact of Brexit and the possible risk of renationalisation, whether with or without sufficient compensation, are all affecting the potential for M&A.

FW: What is the outlook for consolidation in the UK energy market through 2019 and beyond? How is this likely to affect competition?

Staples: As shown by the failed npower SSE deal, the energy supply sector is not an easy market for deal making. That said, there are deals happening in the North Sea and in renewables.

Knight: Arguably, the renewable energy market is de-consolidating and diversifying. The big question is who will manage how new generation energy is integrated into the grid network, along with the shift in customer demand. Arguably, storage and the tariff comparison rate can be seen as ways to address this, but a comprehensive solution across all generation types, renewable or otherwise, has yet to take form.

Johnson: The outlook for consolidation in the UK market depends on what we understand consolidation to mean. It is often used to talk about direct competitors merging or acquiring one another, reducing the number of competitors in a field. However, two meanings that could apply are 'to

> WE CAN FORESEE COMBINATIONS FROM NON-TRADITIONAL ENERGY COMPANIES, WITH TECHNOLOGY COMPANIES ABLE TO MANAGE CLIENT RELATIONSHIPS POTENTIALLY BUYING INTO ENERGY SUPPLIERS.
>
> COLIN JOHNSON
> Charles River Associates

become, or cause something to become, stronger and more certain' or 'to combine several things, especially businesses'. We can foresee combinations from non-traditional energy companies, with technology companies able to manage client relationships potentially buying into energy suppliers. We may also see further investment in renewables by the oil majors and sovereign wealth funds building renewables portfolios in the UK and elsewhere. It is already happening, but firms with a need to be greener, with deep pockets and long-term horizons, can afford to be serious investors. Similar arguments apply for why many of the major technology companies are also becoming serious renewable energy investors. In a different direction, difficulties among a number of smaller suppliers potentially indicates more forced consolidation going forward in the more traditional sense of the word. Finally, one trend that will potentially lead to more fragmentation first, before such companies do consolidate into a smaller number, is decentralised power production. There will initially be smaller producers taking advantage of existing and new technologies to develop projects but then later acquisitions to achieve synergies of scale and scope.

> CARBON COSTS HAVE RISEN SHARPLY IN RECENT MONTHS, AND THIS CAN PROVIDE A BOOST OR A BLOW TO POWER PRODUCERS.
>
> JAMES KNIGHT
> Augusta & Co.

Davies: We expect a slight slowdown in new M&A activity on the UKCS over the next few months as the market digests the deals currently going through. However, disappointed under-bidders in recent sales processes are likely to remain on the lookout for quality assets, so we see the prospect of further significant portfolio deals and some large strategic combinations later in 2019 and into 2020. From a power and renewables perspective, we expect to see some further strategic reshuffling of thermal generation portfolios. We also expect the oil & gas majors to continue their push into the power and renewables market, right across the value chain – the big question is whether they will look to do that through relatively small incremental steps as they have done to date, or whether they will look to do something more transformational. ■

This article first appeared as exclusive online content for July 2019 on www.financierworldwide.com. Permission to use this reprint has been granted by the publisher. © 2019 Financier Worldwide Limited.

FINANCIER WORLDWIDE corporatefinanceintelligence