Key Takeaways

Skadden

Energy M&A Webinar Series: Utility M&A Update

Contacts

Pankaj Sinha
202.371.7307 (Washington, D.C.)
pankaj.sinha@skadden.com

Clifford (Mike) M. Naeve
202.371.7070 (Washington, D.C.)
mike.naeve@skadden.com

Katherine D. (Kady) Ashley
202 371.7706 (Washington, D.C.)
katherine.ashley@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

On January 28, 2016, Skadden hosted a webinar titled "Utility M&A Update," the first installment of a three-part Energy M&A Webinar Series focused on transactional trends in the energy industry. The program, which drew 140 attendees, addressed topics such as general developments in the power/utility industry, the impact of industry consolidation, utilities shedding non-core assets, regulatory approvals and lessons learned, regulatory risk sharing in M&A agreements and a 2016 outlook. Skadden speakers included partners Pankaj Sinha, Mike Naeve and Kady Ashley.

Power/Utility M&A Developments

Mr. Sinha, leader of Skadden's Washington, D.C. mergers and acquisitions practice, kicked off the webinar by discussing recent M&A trends and developments. Mr. Sinha noted that although overall M&A deal volume increased from 2014-15, deal volume actually declined in the power/utility and energy sectors, totaling $267.8 billion, only 11.4 percent share of the 2015 M&A deal market. He highlighted recent selected deals in the industry, breaking each down by its equity transaction value to underscore the magnitude of deals that are common to this sector. Mr. Sinha also noted Duke Energy's recent $4.8 billion acquisition of Piedmont Natural Gas and Southern Company's $8 billion acquisition of AGL Resources as examples of a recent stream of large transactions in which regulated electric utilities have acquired natural gas companies.

Impact of Industry Consolidation

Mr. Sinha continued the program by discussing the impact of consolidation in the utility industry. He noted that the number of U.S. investor-owned electric utilities has declined over the past two decades, falling from 99 such utilities on December 31, 1995, to just 46 by December 31, 2015 (according to the Edison Electric Institute). Expanding further on this point, Mr. Sinha broke down the number of utilities over time by market capitalization, underscoring that utilities continue to grow larger with continued consolidation over time, eroding much of what had comprised the low/mid-cap companies in this sector. On December 31, 1995, only 2 percent of electric utilities had a market capitalization in excess of $10 billion, but as of December 31, 2015, 41 percent had surpassed $10 billion in market capitalization (according to Edison Electric Institute). In addition, Mr. Sinha discussed a trend in which companies in the industry are selling off non-core assets. On this point, he explained how regulated utilities have moved away from competitive and deregulated markets in recent years in an effort to lower their risk profile and retreat to core (regulated) businesses.

Regulatory Approvals and Lessons Learned

Mr. Sinha introduced the next topic by first providing an overview of a typical M&A transaction and then referencing the same deals he discussed earlier. However, this time he broke down each transaction by the number of state regulatory approvals required and the length of time it took to consummate, hitting on a theme of prolonged timelines associated with deals in this sector and illustrating how the exact amount of time is often ultimately a function of the number of different regulatory approvals required.

This provided context for Mr. Naeve, a partner in Skadden's energy regulation and litigation practice, to provide a primer on the regulatory approval and review process required for power/utility transactions and discuss significant related considerations and concerns. Mr. Naeve gave an overview of the typical approvals required and summarized the entire review process, which includes handling federal filings required under FERC, the FCC and the Hart-Scott-Rodino Act; obtaining state and local approvals required under statutes and public utility commission (PUC) regulations; addressing regulators' specific concerns and approval standards; and handling a wide array of conditions or commitments that regulators may impose. Mr. Naeve described how regulated companies face numerous challenges before successfully closing a deal because of the risks associated with such a complicated and prolonged regulatory approval and review process; the uncertainty and inconsistency associated with various state statutes and PUC regulations; and the potential for expensive, regulator-required conditions. Finally, he discussed recent developments and potential changes to the regulatory approval and review process, and touched on how such changes may impact the considerations discussed.

Regulatory Risk Sharing in M&A Agreements

Ms. Ashley, a partner in Skadden's mergers and acquisitions practice, discussed how the aforementioned regulatory concerns and risks can be addressed in negotiations, merger agreement provisions and deal structures. Ms. Ashley presented an overview of the top negotiation issues common to transactions in this industry. She then detailed one common major issue — regulatory risk sharing provisions/standards in M&A agreements. Regulatory risk sharing requires diligent negotiation of terms to facilitate the regulatory approval process, outline the cooperation and efforts required by each party, and properly allocate between the parties the risk of a failed approval or unacceptable conditions and commitments being imposed by a regulator. She provided examples of specific regulatory risk provisions in this context from recent deals, explaining how various constructions range from buyer-friendly to seller-friendly provisions. In addition, Ms. Ashley discussed the use of operating covenants in utility deals — agreements often will include covenants addressing industry-specific matters such as the conduct of business in accordance with good utility practices and procedures for rate matters. She explained how parties often will establish a transition committee composed of members of both companies to oversee integration planning. Finally, Ms. Ashley touched on HR/employee benefit, corporate governance and social issues that frequently arise in negotiating power/utility deals.

2016 Outlook

The partners closed the webinar with their thoughts on where the market is headed in 2016. Mr. Sinha discussed how utilities will continue to merge to achieve size and cost advantages in light of weak earnings, regulatory changes and challenges from nontraditional competitors, but qualified that with a caveat: With fewer utilities, there may be fewer opportunities for consolidation. Mr. Naeve posited that the increased market concentration in independent system operator and regional transmission organization markets might make larger transactions more difficult, but we should expect to see continued consolidation among generating companies. Regulated U.S. utilities have become increasingly attractive for infrastructure funds, private equity and foreign investors, and Mr. Sinha discussed how this trend is likely to continue because, among other things, rates of returns are attractive relative to the Federal Reserve interest rate, investors are willing to pay more for certainty in earnings and for regulated (as opposed to unregulated) assets, and U.S. utilities trade at a higher multiple than many foreign utilities. He further discussed the expected growth in wind and solar renewable energy projects in light of Congress extending the renewable energy tax credits in December 2015 and providing long-term assurance/certainty and a predictable level of subsidy to investors seeking to rely on the credits. Mr. Sinha concluded that the trend of regulated electric utilities acquiring natural gas companies, a topic introduced earlier in the webinar, is likely to continue, again highlighting the Duke Energy/Piedmont Natural Gas and Southern Company/AGL Resources acquisitions.