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# M&A ACADEMY

## M&A Trends and Pitfalls in Power and Utilities Transactions

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- **Generation Transactions**

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- IV. Market Trends / COVID-19 Updates

- **Key Takeaways**

# Types of Power and Utilities M&A Transactions

- Regulated utility transactions (electric, gas, water)
  - Involve companies providing retail distribution service to customers (e.g. wires and pipes that run into homes and businesses)
  - Heavily regulated by state and federal regulatory bodies
  - Cost-based rate regulation; prudently-incurred business costs are passed through to customers (subject to regulatory process and timing lag)
  - Majority of transactions are public deals
    - Most investor-owned utilities are public companies
    - Many are cash acquisitions, but largest deals are stock-for-stock mergers
- Strategic buyers dominate large deals
  - Some Canadian and European strategic players in the U.S. market
- Several financial buyers active as well (particularly mid-market and minority interests)
  - Consistent regulated returns are attractive in a low interest rate environment

# Types of Power and Utilities M&A Transactions

- Competitive / “unregulated” power transactions
  - Involve sales of wholesale generation (including renewables) and energy storage
    - Businesses that do not “face” retail customers directly
  - Regulated by state and federal regulatory bodies but typically exempt from most onerous requirements; no cost-based rate regulation
  - Majority of transactions are private deals
    - Most generation owned by private entities; only two public generation companies remain
    - Almost universally structured as stock/equity purchases
    - Deals involving regulated utility sellers or buyers may be structured as asset sales
  - Financial and strategic players (including regulated utilities) both very active
    - Financial players include private equity, infrastructure funds, pension funds

## **Types of Power and Utilities M&A Transactions**

- Some other types of power M&A transactions
  - Transmission utilities (federal cost-based rate regulation)
  - Competitive retail businesses (limited state regulation; consumer protection regulation)
  - Decommissioning sales (mostly nuclear sites with decommissioning funds)

# **Regulation of Power and Utilities – Brief Overview**

- The generation, transmission, distribution and sale of electric power is subject to extensive regulation, by both the state and federal governments (as well as some quasi-regulatory entities), which can have a profound impact on the commercial aspects of a transaction
- Federal Energy Regulatory Commission
  - Regulates rates for electric transmission and wholesale electric sales
  - Exercises broad jurisdiction over electric sector mergers, acquisitions and dispositions
  - Most U.S. wholesale electric generators, power marketing businesses and investor-owned electric utilities are considered “public utilities”

# **Regulation of Power and Utilities – Brief Overview**

- State public utility commissions
  - Regulates rates for electric distribution and retail electric sales
  - Typically must approve dispositions involving investor-owned utilities operating within the state
    - May have limited regulation over electric generation transactions within the state
  - Primary regulators for investor-owned utilities
  - Multi-state utility companies may be regulated by multiple state commissions
- Other governmental authorizations common in electric sector transactions:
  - Hart-Scott-Rodino (antitrust)
  - Committee on Foreign Investment in the U.S. (for foreign investors)
  - Federal Communications Commission (radio licenses used for operations)
  - Nuclear Regulatory Commission (for nuclear generation/sites – must remain under control of U.S. persons)

## **Utility Transactions – Regulatory Considerations**

- Many key commercial issues are driven by regulatory considerations
- Federal and state regulatory approval timeline is protracted
  - State public utility commission approvals may take 6 to 12 months (depending on state)
  - Termination “outside dates” typically can be extended unilaterally to 18 months or longer to allow for regulatory approval process
  - May need to stage applications (e.g. HSR, FCC) to prevent expiration before closing
- Sellers must carefully weigh regulatory risk when evaluating offers
  - Deal certainty is often more important than price; need to consider state regulatory reception to proposed buyer
    - May impose unique additional pressure on a seller’s board of directors
  - Strategic buyers have dominated the market; financial buyers have more difficulty obtaining regulatory approvals and accepting all regulatory risk

## **Utility Transactions – Regulatory Considerations**

- Recent deals use all/mostly cash consideration, but mostly/all stock consideration are likely to become more prevalent in the future
  - Stock consideration results in less leveraged acquisition structures, which are viewed more positively by regulators and ratings agencies
    - Several recent transactions have been rejected or otherwise highly scrutinized by regulators due to the amount of acquisition debt
  - Allows strategic acquirers to use highly-valued stock as currency
- FERC approval process has been straightforward in most recent utility transactions and sometimes involves mitigation measures
  - Chief concern is review of combined “market power” (some similarities to antitrust review)

## **Utility Transactions – State Commission Approval**

- State regulatory approval process is often difficult and involves real risk
  - Transaction approval standards typically “no net ratepayer harm” or “net ratepayer benefit”
  - Large transactions have been rejected by state commissions (e.g. NextEra/Oncor, Hydro One/Avista, NextEra/Hawaiian Electric), restructured to obtain approval after rejection (e.g. Great Plains/Westar) or initially rejected followed by approval after additional concessions were made to regulators (e.g. ENMAX/Emera Maine, Macquarie/Cleco, Exelon/Pepco)
  - Regulators demand significant commitments from buyers to approve transactions
  - Regulators and interveners look to recent commitments made in other transactions across the U.S.; each new transaction builds upon prior transactions
  - Trend is that regulators are increasingly aggressive and upfront commitments are increasingly burdensome on buyers
- State commission rejections are rarely appealed – there is often no practical recourse for parties
  - Contractual “outside dates” typically do not allow for a long appeals process after an initial rejection
  - Extending the process is often impractical for commercial reasons
  - Courts are deferential to regulatory commissions, making a successful appeal difficult

## **Utility Transactions – State Commission Approval**

- Regulatory commitments from recent transactions include:
  - Rate credits to customers (immediate and over time)
    - Recent transaction involved both buyer and seller-funded credits
  - Multi-year rate freezes or rate case “stay outs”
  - Commitment to maintain local employment levels, headquarters, charitable contributions
  - Ring-fencing / bankruptcy-remote structuring
    - May impact buyer’s financing capabilities
  - Restrictions on shareholder distributions; minimum equity levels
  - Independent director requirements (substantial or majority independence)
  - Minimum holding period before a subsequent change in control
  - Hold harmless commitment for transaction costs/impacts
- Buyers should make upfront evaluations of likely commitments to inform their valuations
  - Board materials on valuation can be requested/discovered during regulatory approval process

## **Utility Transactions – Allocation of Regulatory Risk**

- Typical regulatory risk allocation reflects a long-running “sellers’ market” for utility transactions
- Regulatory approval strategy important to discuss before signing
- Trend over last 5 years: Buyer wears regulatory approval risk
  - Buyer must pay regulatory termination fee if regulatory approvals not obtained for any reason
  - Regulatory termination fees recently in the range of 5% or more of purchase price (or equity value); amount not limited by fiduciary concerns applicable to fiduciary termination fees
- Buyer typically commits to “hell or highwater” regulatory covenants
  - Must take all actions needed to obtain regulatory approval, including agreeing to concessions/commitments
  - Buyer is not required to close over a Burdensome Condition or agree to concessions/commitments that would result in a Burdensome Condition
  - Buyer must still pay regulatory termination fee if it does not close due to Burdensome Condition

## **Utility Transactions – Allocation of Regulatory Risk**

- Burdensome Condition (i.e. Regulatory Material Adverse Effect)
  - “Material adverse effect” resulting from regulatory commitments and conditions required to obtain regulatory approval of the transaction
  - Heavily negotiated items: measurement size (target company alone or combined buyer plus target company), multiple of measurement size, excluded items
  - Parties sometimes develop an initial list of regulatory commitments to be announced with the transaction; typically that list is excluded from Burdensome Condition determination
- Burdensome Condition is very high but imprecise threshold
  - Specifying a specific dollar amount impractical due to regulatory disclosure dynamics
  - Regulatory termination fee amount operates as implicit yardstick

# **Utility Transactions – Commercial Issues and Pitfalls**

- Interim covenants cover a long period of time due to regulatory approval timeline
  - Need to balance buyer protection with flexibility to keep running business
  - Rate case management/settlement, collective bargaining negotiations, dividend restrictions
  - Fewer negotiation controversies in stock-for-stock mergers; covenants can be more mutual
- Tax basis step-up structures cause rate/regulatory issues for utilities
  - Basis step-up structures (e.g. Section 338(h)(10) election) are typically desirable from a purely economic perspective and result in higher valuations
  - However, a basis step-up results in a reset of the target company's accumulated deferred income taxes (ADIT)
  - ADIT is used to reduce a utility's cost of service customer rates; resetting ADIT effectively results in higher customer rates upon closing the transaction
  - Income tax normalization rules limit ability for a utility to mitigate customer rate increases caused by ADIT reset; cannot directly offset through rate credit

## **Utility Transactions – Commercial Issues and Pitfalls**

- Utilities have unique ability to mitigate certain business risks
  - Cost-based rate recovery
  - Eminent domain authority
- Indemnities
  - Effect of rate recovery on buyer's mitigation obligation
  - Seller demands for "public-style" transactions (no indemnities), even in private deals
  - Representation and warranty insurance considerations

# **Utility Transactions – Key Diligence Issues**

- Regulatory issues
  - Current rates; rate case schedule
  - Regulatory policies that impact valuation assumptions (e.g. treatment of holding company leverage)
  - Existing regulatory commitments; prior M&A commitments
- Labor and employment
  - State statutory protections for utility workers
  - Collective bargaining agreements
    - Successor employer clauses
    - Term length and timing of renegotiations
  - Pensions and retiree medical issues
    - Rate treatment adds complexity
- Cyber-security/breaches; customer data protection/privacy

## **Utility Transactions – Market Trends / COVID-19 Updates**

- Utility industry has trended toward continued consolidation
- Recent utility deals have been auction processes, resulting in cash deals with high premiums
  - Regulators have resisted highly-leveraged cash acquisitions
  - Processes will remain competitive; likely to see more stock consideration and lower premiums
  - Mergers of equals may be possible, but fewer sensible partners
- COVID-19 raises uncertainties for the near term
  - M&A market across industries has slowed for new transactions
  - Utilities are experiencing additional costs with uncertain regulatory recovery
  - Will regulators negatively react to any M&A transactions during this period of intense focus on public health and safety?
  - Likely to be greater focus on diligence of key areas
    - Bad debt recovery/receivables purchase programs, business continuity, liquidity, health and safety, rate recovery of extraordinary costs, cybersecurity, privacy
    - All in context of heightened pressure to avoid customer rate increases

## **Generation Transactions – Commercial Issues and Pitfalls**

- Interim covenants and timeline
  - Much shorter regulatory approval timeframe; closings often in the 3-6 months timeframe
  - Capital expenditures
  - Hedging and risk mitigation transactions
- Indemnities
  - Much conventional generation is owned by private equity and infrastructure funds
  - No indemnity structures and representation and warranty insurance becoming more common
- Environmental
- Casualty/condemnation

## **Generation Transactions – Key Diligence Issues**

- Project agreements: power purchase (PPAs)/offtake, operations & maintenance (O&M agreement), energy management (EMA), equipment long-term service agreements (LTSA), asset management agreements, fuel supply/capacity, interconnection agreements
- Risk policies and hedging
- Regulatory compliance and permitting
- Financing and credit support
- Environmental
- Real estate
- Employees and benefits (if applicable)

## **Generation Transactions – Build/Sale Transactions**

- Build-sale transactions
  - Construction of new generation; primarily renewables (wind, solar)
  - Sales closes upon project meeting construction milestones (e.g. mechanical completion, substantial completion/commercial operation)
  - Key issues driven by tax equity and project financing
    - Often large number of closing conditions, similar to financing agreements
    - Tax credit qualification (PTC, ITC); allocation of tax credit risk
  - Diligence focuses on development and construction issues and project contracts
    - May coordinate diligence with tax equity and lenders
  - Wind projects issues
    - Modularity; holdback turbines
    - Real estate matters can be significant

## Generation Transactions – Market Trends / COVID-19 Updates

- Most new generation being built is renewable (wind, solar); some gas plants; no new coal plants
- Energy storage still ascending; processes continue
- COVID-19 issues
  - Conventional generation sales have slowed down
  - Renewable generation market still generally robust, but some uncertainty for new transactions
  - 2019 projects are being impacted by supply chain, permitting and construction delays
  - Delays are causing uncertainty with tax equity financing
    - To qualify for 100% PTC, projects that began construction in 2016 must be completed by December 31, 2020 to qualify under the continuous construction safe harbor rules
    - Industry trade groups advocating 1-2 year safe harbor extension but Congress has not yet taken any action
    - Sponsors are developing fallback structures to account for excusable delay if Congress takes no action, but uncertain whether tax equity sponsors will accept
  - Buyers are evaluating Material Adverse Effect clauses across industries
    - Likely to see more pandemic carve-outs
    - More MAE litigation and jurisprudence likely, similar to the spate of MAE cases from the financial crisis (e.g. *Bed Bath & Beyond v. 1-800-Flowers.com* pending in Delaware)

## **Key Takeaways from This Session**

- Utility and power transactions present the typical “suite” of M&A issues, but the unique regulatory issues and risks put an enhanced focus on certain contractual provisions
- Key commercial contract terms need to be carefully integrated with the regulatory requirements and process
- In evaluating transactions, Sellers and their boards may need to weigh heavily the nature of the buyer due to the intense scrutiny put on potential buyers by regulatory authorities
- In competitive generation transactions, there is greater focus on project-level issues
- COVID-19 is starting to impact the power and utilities sector in the short-term; long-term impacts are still speculative

# Biography



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John Klauberg represents companies involved in high-level transactional matters in the utility and electric power sectors. He guides clients through mergers and acquisitions of regulated utilities; acquisitions and dispositions of power generation facilities and similar “utility-type” properties, as well as wholesale and retail electric and gas contract portfolios; and various types of joint venture arrangements in the power and energy sector, including matters involving both generation and electric transmission facilities. He currently serves as deputy practice group leader for the firm’s project finance, infrastructure & natural resources practice.

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# Biography



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Michael Espinoza advises on energy transactions, with a focus on power, gas, regulated utilities, and renewable energy. He represents clients on a variety of deals, including mergers, acquisitions, and divestitures involving electric generating facilities, regulated electric and gas utilities, retail electric providers, and electric transmission facilities.

Mike also represents clients on power purchase and offtake agreements, project agreements for traditional and renewable projects and joint venture, partnership, and other investment structures involving the development and ownership of electric generating, storage, and transmission assets.

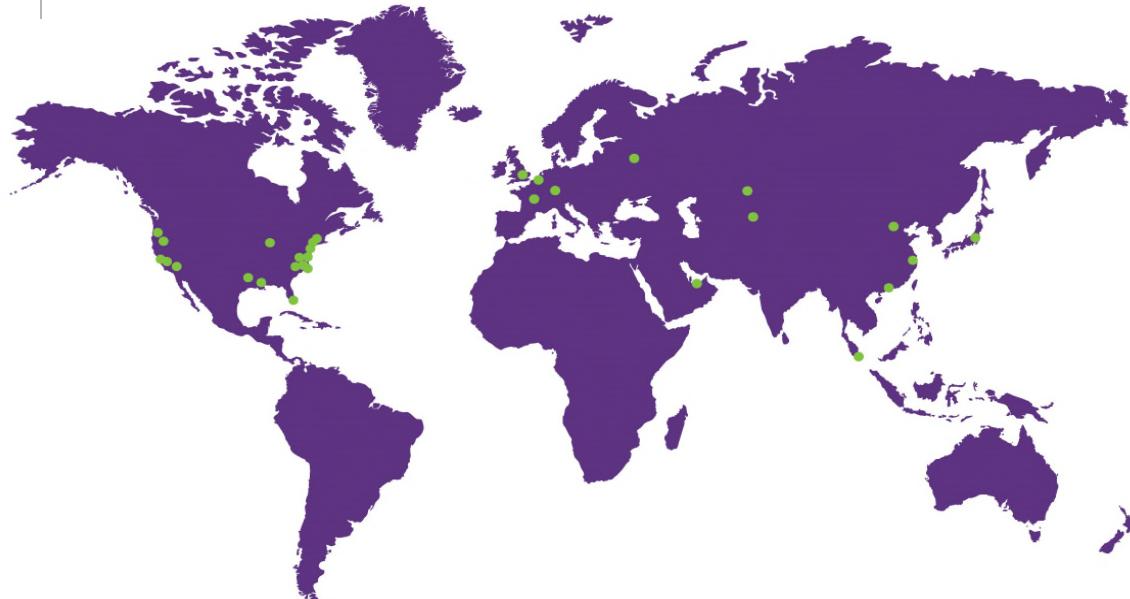
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