At the crossroads
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As renewables rise, natural gas nosedives – and shale gas changes everything – mergers and acquisitions (M&A) are becoming an increasingly significant fixture on the power and utilities (P&U) landscape. We spoke to Ernst & Young’s Global Transactions Power & Utilities Leader Joseph Fontana for his view on a truly transformative time for the industry.

Based in Ernst & Young’s New York office, Joseph Fontana has almost 30 years of experience in corporate finance and transactions, 20 of them in power and utilities. He says that current market conditions are some of the most interesting he’s worked through.

Appetite for risk

As companies adapt to dramatic shifts in the industry, caused, most notably, by decade-low natural gas prices and the shale gas boom, Joseph says the strategies adopted by P&Us as they attempt to protect revenue are intriguing.

“Different companies are reacting to the same situations in different ways,” he explains.

“Many utility companies are facing low power prices, and it’s interesting how some companies decide to go one way and other companies go a different way. Some are willing to continue to have a higher percentage of generation assets – and so have more volatility in their portfolio – while others are keen to significantly reduce that volatility.”

“Either way, there are M&A opportunities as these companies look to get to the right mix of competitive businesses and regulated businesses.”

Secrets of success

Transactions may be reshaping the P&U sector, but not all are successful. In his years of supporting clients through the process, Joseph says he has come to recognize the hallmarks of a successful merger or acquisition – and the warning signs that a deal may fall short of expectations.

One of the classic mistakes is underestimating the regulatory process.

“Utilities that underestimate the effort and time it will take to get regulator approval may experience a delay in getting the transaction approved or even find the regulator demanding so much that the deal becomes economically unviable,” Joseph explains.

“For example – let’s say you have two utilities that are merging. Regulators may demand the sell-off of certain generation assets after the deal closes. These generation assets may have been the true jewel of the deal, so selling off these assets means the deal is no longer economical.”

“It is important that utilities take the time to understand just what the regulator will expect before they embark on a transaction.”

Joseph also says that utilities that complete successful transactions are those that retain the key officers of the merged companies after the deal is done.

“This means you can keep the knowledge and experience of these people. Many times utilities will try to reduce the workforce to make a deal more economical, but losing the experience of key people may reduce the chances of a successful outcome,” Joseph explains.

Another feature of successful transactions is the ability to achieve the synergies first envisioned and fully realize their economic benefits.

“This may mean achieving savings through greater purchasing power, reducing costs through eliminating duplicated workforces or aligning IT systems between merged companies.”
Push for renewables

Looking ahead, Joseph says that President Obama’s second term will bring more changes to the US P&U sector and further impact transactions.

“We expect the Environmental Protection Agency (EPA) to push ahead with new rules that may make it uneconomical to run some older-technology power plants — operators may close or shut down some units.”

Still, he says, the market may also see benefits via an upward pressure on power prices due to EPA actions.

“I think we will see continued efforts to support the alternative energy industry within the US, and that will be a strong plus for developers of alternative energy, such as wind, solar and biomass plants.”

“On the downside, these technologies are still more expensive than conventional power and so, as more of these units are put in place, the more expensive power gets in relation to where it was before.”

Joseph says that US tax incentives, as well as obligations under the Renewable Portfolio Standards, “help create a market for renewables and will drive opportunities in that space.”

He points out that “typically, transactions in this sector are around bringing investors into projects that are in development rather than seeing buyers acquire, for example, a completed wind farm.”

The human element

Whatever the future holds, it is an exciting time for P&U transactions as companies react to changing market conditions, and, while economic factors may underpin their decisions, Joseph points out that “the human element” plays an important part too.

“How different companies react to these very volatile situations is often determined by each company’s individual corporate culture,” he explains.

“When we talk about how much risk they are willing to live with, it often comes down to the personalities of the management team and their inherent skillset. And, quite frankly, some of them may have a completely different point of view as to how the market will turn out, and this will influence the strategies they decide on,” he says.

“Being able to help our clients execute those different strategies is exciting and really quite a lot of fun.”

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Joseph has almost 30 years of corporate finance and transaction experience, of which, 20 years were in the power generation and utilities sector. He has led numerous transactions for strategic buyers and private equity investors in this sector, including electric and gas utilities, independent power producers, electric and gas marketing companies, gas pipelines, LNG plant construction projects, gas storage and transmission and distribution outsourcing.
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