Sidley Energy Roundtable 2017

Opportunities and Challenges on the Horizon

With fossil-fuel prices on the rise and an industry-friendly regime taking power in Washington, the energy sector is poised for a rebound in 2017, according to three leading energy lawyers. Supported by the Trump administration's "embrace [of] the shale oil and gas revolution,"[1] the industry will shake off its two-year slump on the strength of a widespread restoration of balance-sheet health that should help spur deal making, while investment and macro developments should address the recent supply-demand imbalance.

That was the consensus when Jim Rice, Irv Rotter and Ken Irvin gathered for a roundtable discussion at Sidley Austin LLP's offices in Houston. Sharing insights on the current energy climate with a group of journalists, the lawyers provided three distinct views of the industry – with each concurring that 2017 would likely see a return to normalcy and stability in energy markets.

The resurgence will be fueled largely by a recovery in oil prices, which bottomed out at less than $30 a barrel in early 2016 but have recently topped $50 a barrel. As prices rebound, deal activity should as well, sustaining the momentum from late 2016, which witnessed a flurry of mega-deals with a transaction value of more than $1 billion.

"We'll have a good 2017," Rice said. "E&P balance sheets have been repaired through a lot of restructuring, in some cases resulting in new ownership, and the industry as a whole is positioned to pivot from asset sales to asset acquisitions."

[1] https://www.whitehouse.gov/america-first-energy

Oil & gas: Motivated sellers, active buyers

Those new owners include many financial players – such as distressed investment firms or hedge funds – who aren't in the business of producing oil and gas; Rice expects them to begin looking for opportunities to exit their investments in 2017. And sellers should find plenty of interested buyers, as strategic investors use their rejuvenated balance sheets to pursue growth through acquisitions.

Rice believes the Permian Basin in West Texas will continue to draw particularly keen investor interest. The 75,000-square-mile region continues to provide superior economics, with operators extracting more from Permian resources at better margins than any other active basin. The concentration there is also growing as many operators, following three years of belt-tightening, focus their attention on no more than two or three basins. Investors have taken notice of the Permian's attractive economics as well, availing operators there of ample capital from strategic and private-equity investors alike.

"Last year strategics seemed to be saying 'let's be a core-basin operation,' taking the approach that they should put more resources and capital in fewer basins," Rice said. "The trend is toward specializing your operations and presenting yourself as, say, a Permian Basin story plus one or two other basins."

A sustained recovery in natural gas prices should propel activity as well, Rice said. While the rebound in gas markets hasn't been as robust as in oil, there has been a steady climb upward, with prices achieving two-year highs in mid-January.

Rice also sees positives for the natural gas producers with export opportunities to Mexico, and U.S. LNG export capacity coming on line of up to 15-18 billion cubic feet of production per day by 2020 – both developments having the potential to alleviate the persistent gas supply-demand imbalance, which has resulted in historically low prices for the commodity.

Renewables: A new era of uncertainty

While most indicators point toward optimism in oil and natural gas, renewables face a more uncertain year ahead. The November election results raised a number of questions regarding the increased use of fossil fuels and policies favoring renewable energy.

President Trump has repeatedly stated his desire to assist the coal industry and to increase domestic production of natural gas and oil. While lightening the regulatory burden on fossil fuels will be helpful, coal will continue to confront significant challenges. Over the past several years, the use of coal in power generation has been declining steadily as utilities substitute natural gas as a fuel for baseload generation and renewables comprise an increasing portion of the generation stack. Absent some exogenous event, such as a marked increase in the price of natural gas, regulatory intervention requiring generation diversification or some other assistance, it is unlikely that new coal facilities will be developed or that a significant portion of the existing coal fleet will remain economically competitive.

With regards to renewable energy, extension of the production tax credit (PTC) helped spur greater activity in wind projects in 2016. However, wind projects have been heavily dependent on tax equity and projects under development could face significant challenges if the administration's plan to lower the corporate tax rate were adopted. At the end of the year a number of significant early- to mid-stage

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—IRV ROTTER

wind project development transactions were either put on hold or restructured as buyers elected to wait and see whether and how the tax code would change. For wind projects that were in the process of obtaining tax equity, the prospect of a change in the tax code injected an element of economic uncertainty and, in a number of cases, investors requested indemnification for any change in tax law. If corporate tax rates are reduced, the cost of tax equity is likely to increase which, absent an increase in the price of power, is likely to reduce the developer’s return. For projects with strong economics, a change in rates and a correlative increase in the cost of tax equity may make other equity capital more competitive; for marginal projects, a change in rates may result in those projects not going forward.

Solar projects are less dependent on tax equity and, absent a change in the investment tax credit, are less likely to be adversely impacted by changes to the tax laws. Nonetheless, the change in administration still may have significant effects. President Trump’s statements regarding trade particularly as related to China, if adopted as policy, could have a significant effect on the cost of solar modules and could make solar projects less competitive. In the past, the market has been able to absorb increases in duties but it remains to be seen if there will be additional duties and whether the market will continue to absorb any such increases without significantly adversely affecting development.

While renewable energy sources face significant challenges, there are, however, significant positive signs that augur well for continued growth. Federal policy may change, but many state policies will continue to provide incentives for development of renewables. And in the past year there has been a shift in the profile of renewable-power purchasers as increasing numbers of power purchase agreements are signed by commercial and industrial customers (C&I) rather than traditional utilities. The increase in C&I agreements appears to reflect a response by these customers to the public’s desire for increased use of renewable sources. “I believe commercial and industrial users entering into power purchase agreements and energy hedges for renewable energy is likely to continue,” Rotter said. “But the overall outlook for the development of new facilities remains murky.”

Regulatory & political outlook: Shifting winds

From the makeup of his cabinet to the first days of his administration, President Trump has sent clear signs that his administration will steer federal policy away from imposing limits on carbon emissions and toward increased support for fossil-fuel production. This is seen in President Trump's promise to eliminate the Climate Action Plan and the Waters of the U.S. rule.[2] Abandonment of the Clean Power Plan will not only create anxiety among renewables operators and investors, but could lead to significant changes in the supply mix for power generation.

The new administration may contribute to blurring the line between federal and state jurisdiction for our energy markets. Last year the U.S. Supreme Court issued a pair of rulings declaring states had unlawfully intruded on FERC's authority by attempting to intercede in interstate markets in hopes of assisting power generators. But states – for example, those housing nuclear generators – may get more leeway in keeping struggling generators afloat under the Trump administration.

"Prices are clearing lower than the states would like, so they'll get creative in figuring out what to do with those generation resources," Irvin said. "And they may have some success if the new administration turns out to be less protective of federal authority."

The administration has turned over, and so has leadership at two key federal agencies. Most recently, the chair of the CFTC stepped down, as of the inauguration. President Trump also has named Cheryl LaFleur Acting Chairman of FERC and Commissioner Norman Bay announced he will leave FERC on February 3.[3]

At the CFTC, acting Chairman Christopher Giancarlo is perceived as a moderate who may view industry and market regulation through a much more business-friendly lens than his predecessor. At the FERC, we expect to see a significant change in tone as President Trump has three commission seats to fill and maybe a fourth, with Commissioner Honorable's term expiring June 30.

Commissioner Bay's departure leaves the FERC without a quorum and the means necessary to rule on rate filings and other important Commission business, which could mean several rate filings simply become effective by default.

[2] Id.
[3] https://www.bloomberg.com/politics/articles/2017-01-20/trump-said-to-pick-lafleur-as-chairman-of-u-s-energy-regulator

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>
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Acting Chairman LaFleur has said FERC business will continue despite the lack of a quorum, but she also emphasized the importance of a full, five-member Commission. Senator Lisa Murkowski acknowledged the importance of fully-staffed FERC when she promised to prioritize confirmation hearings for President Trump's nominees.

While the makeup of these agencies will change their tone and level of receptiveness to industry concerns, Irvin cautions that anti-manipulation enforcement is unlikely to slow. "Both parties recognize the importance of ensuring compliance, and FERC and CFTC have made a robust effort and collected a lot of monetary penalties," he said. "I don't expect to see any let-up."

President Trump's focus on upgrading infrastructure spending heralds a positive outlook, as does the Republicans' stated preference for public-private partnerships in developing infrastructure. Where that investment will take place remains to be seen, but transmission is a likely candidate, along with pipelines. And there is no shortage of money waiting on the sidelines should the infrastructure spigot be thrown open.

International outlook: Relationships to watch

Political changes and uncertainty could also have a drastic impact on both inbound foreign investment and energy exports in the coming years. The signals from Washington create a mixed bag of potential ramifications for the industry.

While the new administration appears intent on expanding exports such as fossil fuels – a possibility given increased production and the potential for increased infrastructure spending – President Trump has also used protectionist rhetoric that could result in punitive action against U.S. exports by our trading partners.

Much will hinge on relations with Mexico, one of the biggest U.S. trading partners. The recent development of new natural gas pipelines running from the U.S. to Mexico opens new markets for natural gas. With the energy reforms implemented in Mexico, natural gas from the U.S. offers reliable, cost-effective supply. This comes as Mexico works to modernize its electricity grid and establish a nodal market, which operates similar to U.S. regional transmission markets like PJM and potentially offers a wealth of development opportunities for American companies.

The Trump administration's promise to renegotiate NAFTA or failing that withdraw from NAFTA[4] looms as a potential threat to these opportunities. NAFTA has been a significant factor in helping Mexico's interest economy grow, and industrial activity in Mexico is a key factor driving U.S. energy exports to our southern neighbor.

Still, Irvin remains optimistic that the growing opportunities to find new customers and development projects in Mexico will ultimately lead the administration to a sensible trade policy, even if NAFTA is renegotiated.

"There are far too many positives in this relationship," he said. "It can be managed to mutual benefit for both countries."

President Trump's statements and actions are also raising the specter of disruption in inbound investment from China. The Chinese have provided a robust supply of capital into domestic energy markets in recent years and they are ready to invest more. But that capital could be in jeopardy if the U.S. were to take action against what the administration believes to be unfair or improper currency or import policies.

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[4] https://www.whitehouse.gov/trade-deals-working-all-americans

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