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Plugged In

Issues impacting the power and utilities industry

Shaping the future utility – M&A and convergence 2.0

In this edition of KPMG's Global Energy Institute's PluggedIn, we asked Andy Steinhubl, Jonathan White and Mark Coles about recent M&A deals within the power and utility industry, the industry dynamics driving the surge in deals, and the implications for leading players.

1. The recent announcement of the Dominion acquisition of Questar is an example of the surge in large M&A deals between electric and gas utilities. Could you explain the components of this particular deal and provide an assessment of their intent?
The proposed merger between Dominion and Questar is slightly different than some of the other deals we have seen recently between utility and gas companies. This particular deal is weighted toward expansion of company scope, and in particular, geographic expansion into new and high growth potential NW U.S. regional markets. Questar's pipeline is well positioned for investment and value expansion as surrounding states look to meet state power renewable standards and Clean Power Plan requirements. Questar operates in states in which significant amounts of power are generated with coal, allowing for potential growth opportunity as anticipated coal generation capacity retirements occur and replacement is primarily by natural gas, delivered via pipeline.

However, there are elements of financial structure and skill synergies to this deal as well, such as the ability to optimize the Master Limited Partnership (MLP) structures both companies have established, and a related understanding and ability to leverage infrastructure hubs to drive future organic investment and drop-down asset opportunity. More specifically, Questar's pipeline business complements Dominion's existing NE U.S. position, and brings existing and future high drop-down potential Questar assets to Dominion's MLP. In light of Dominion's currently more volatile, higher risk midstream asset drop-down candidates, the Questar acquisition allows for a reprioritization of the drop-down time line.

Welcome to the fifth edition of Plugged In, the KPMG Global Energy Institute's monitor of key issues for decision makers in the global power and utilities sector. Plugged In offers insights from KPMG thought leaders on the trends that are driving power and utilities companies today.

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2. Regarding other recent large M&A deals between electric and gas utilities (Southern-AGL, Duke-Piedmont), how are the drivers the same as, or different from the Dominion and Questar merger?

The drivers for each of these three deals have been different, though each touch on a combination of synergies with existing skills, financial structures, and positions, plus access to new growth opportunities. The Duke-Piedmont deal appears to be primarily driven by alignment of core utility and regulatory management skills, leveraging reputation and relationships, and potentially pooling views and skills on customer excellence. During an October 26, 2015 investor presentation, Duke CEO Lynn Good noted "…the merger presents opportunities for Piedmont and Duke Energy to share customer service best practices and focus on providing an effective and dependable service experience for our customers."

Additional synergies include the fact that Duke and Piedmont were already co-investors to develop, construct, and operate the Atlantic Coast Pipeline to provide a new supply of natural gas for Duke's electric generation, as well as serve demand growth at Piedmont. Thus, the combination will provide Duke with a new growth platform, further expand gas fuel supply access for Duke's natural gas-fired electric generation growth, and leverage regulatory and customer synergies.

The third recent mega electric-gas deal, Southern Company-AGL, is driven by yet again by a unique set of drivers. Southern leadership acknowledged the long-term trend to gasify its generation fleet and its growing gas-related investment positions including "anchor tenant" positions in new regional gas infrastructure. Merging with AGL is a path to both synergize with Southern's own gasification needs as well as participate in the broader regional gas growth play in the SE U.S. driven by shale gas. The anticipated growth in regional gas demand and infrastructure requirements exceeds that of Southern's existing core electricity business growth. Hence, the combination both captures synergies and enhances growth prospects.

3. Are these electric and gas convergence deals the only kind we are seeing in the power industry, or are there other types of M&A deals occurring? Why?

There is actually a quite wide spectrum of deals that are occurring within the industry today. First, for example, the multiyear trend of investor-owned utility consolidation continues to be a strong M&A driver. Utilities in the current environment continue to be challenged to achieve top-line growth in light of limited economic (and therefore power demand) growth, ongoing energy efficiency improvements, and the continued influx of often nonutility-supplied green power. Hence, bottom line synergies to drive profit growth (instead) through shared costs and economies of scale-achievable through consolidation-continue to drive M&A attractiveness. The proposed Exelon-Pepco and NextEra-HECO mergers are examples of such "like to like" combinations.

Second, we are seeing multiple players acquiring nonregulated assets and entities for entering nontraditional growth businesses, typically renewable power-related. This includes utilities such as Duke Energy's acquisition of REC Solar. Nonutility players are also engaged. For example, Apple recently announced issuance of $1.5 billion in green bonds that will be used to invest in renewable energy projects, either as an investor or acquirer. Private equity and other financial players are also active in the renewables market given current weak equity markets and debt access for Yieldcos, and the associated decline in competition and valuation for renewable assets. Financial sponsors such as Berkshire Hathaway-NV Energy, Macquarie-CLECO, and Hunt-Oncor have also stepped in to undervalued utility situations.

Thirdly, anticipated changes and growth opportunities in the U.S. market, relative to other global geographic markets, have driven renewed cross-border M&A activity. Many international markets face more limited economic prospects, steeper approval requirements, and higher inflationary risks than the U.S. market. Recent acquisitions by international buyers with a growth focus included Iberdrola-UIL, Emera-TECO, and Fortis-ITC.

4. Do you see this fertile M&A environment in the power sector continuing?

We do think this trend will continue. We anticipate continued core utility business load and rate growth constraints, yet there are emerging growth opportunities in closely adjacent areas; e.g., renewable energy and regulated and unregulated gas, combined with both U.S. and overseas players eager to improve their earnings profiles and shareholder returns. M&A provides an effective tool for utilities to both gain access to new growth avenues adjacent to their core business, as well as leverage their core skills and low cost of capital across more assets and geographies.

5. What is it going to take to be successful in this new P&U M&A environment?

Given the above set of market forces, we anticipate utility companies will need to be highly prepared to participate in M&A. We advocate that utility company leaders be proactive in shaping their future business model, and leverage the following five best practices to prepare for a period of substantial M&A activity:

- First, leadership across the organization needs to align and clearly define their growth ambitions, and how their approach is competitively advantaged – the means by which the company will create greater value than their competition.
- Second, the company needs to define which markets and business models will help them to achieve their ambition and sources of advantage, and then to identify which potential M&A targets align to those markets and models.
- Third, the company will need to evaluate which of the potential targets offer the best opportunity to achieve their strategy and maximize value.
- Fourth, they need to have the capability to execute the deal, and do so quickly.
- Lastly, the effective integration of the acquired company is key to realizing the expected value.

A final consideration, in light of potentially pursuing multiple deals, would be to make the above practices repeatable. That is, build both an M&A roadmap and playbook to appropriately screen, pursue, complete, and effectively integrate opportunities. This last step enables the company to create an enduring M&A capability versus a one-off pursuit.

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