

## The coming revolution in global electric power

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### INTRODUCTION

As more focus is directed toward refurbishing aging power infrastructure, creating reliable and resilient power distribution networks and transitioning into cleaner, renewable sources of power generation in connection with the increasing urgency of a low-carbon energy future, there is growing demand and interest by potential capital sources to support and finance renewable power investments going beyond traditional energy-focused investors. In particular, traditional or “generalist” private equity investors are becoming increasingly important players in the renewable power sector, especially as barriers to entry into the market have decreased by the development of partnerships with operator-platforms and other structures. Further, we believe that the role of private equity in the transition of the power sector is vitally important as the industry has proven itself to be an efficient source of capital and growth to other industries, and we expect existing public debt pressures and extended timelines many governments are faced with in construction and development of renewable power projects in many parts of the world will encourage accelerating private equity investments in the power sector.[1] In light of this heightened attention given to the power sector by private equity firms which may not have focused on energy assets historically, we have prepared this practical guide on important issues and considerations when investing in this sector, with a focus on financing new platform investments. One likely consequence of the recent U.S. presidential election is that there will be even more investment in and political support for renewable sources in the power sector.

First, it is important to understand the general state of the power sector and why private equity firms are increasingly interested in investing in the industry. The U.S. electricity industry boasts the largest power system in the world with close to 900,000 MW of capacity.[2] This system, consisting of multiple power grids (and increasingly, micro-grids[3]), creates, transmits and delivers electricity to homes and businesses throughout the U.S. A consistent, reliable power network is necessary for continued economic development, especially as the population continues to grow and with it, energy needs.[4] The financing, construction and support of a reliable power network is even more important in emerging markets and developing economies where demand is increasing even more rapidly, and where it will continue to be challenged by the potential impact of carbon emissions that are expected to be generated from existing power generation sources. On the other hand, power supply continues to lag demand in



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many areas, including in some parts of the U.S.[5] This fact, coupled with continued national and world population growth and the importance of a reliable power grid to prosperity, means that the demand for power will only grow, presenting a long-term opportunity for investment returns and relatively rapid deployment of capital.

Increased demand is only one of the many reasons why private equity firms are becoming more interested in the power sector. Another factor is the growing attention given to environmental, social and governance (“ESG”) issues and how ESG can drive value.[6] Asset managers are increasingly being asked to meet ESG disclosure requirements and performance expectations set out by the investors they report to.[7] ESG issues of particular relevance to the power sector include pollution reduction, energy conservation and development of a low-carbon energy economy.[8] In fact, many investors already believe that investing in new power generation technologies will assist them in meeting ESG goals.[9] It has been further reported that many investors are focused on resilience and reliability of the power grid, which has come into greater focus especially in light of the very active hurricane season that parts of the country has faced this year, along with an increased number of other extreme weather events in California and elsewhere.[10] We see this increased interest in our practice regularly and we have advised clients on a variety of matters in the space, including recently representing a client with respect to its financing of the development of specified and future battery storage projects in the United States through a combination of debt and equity financing.

Increased activity in the power sector is also attributable to more traditional market forces driving further deployment of capital to the renewable power market. These include decreases in the cost of capital for renewable investments and technological innovations leading to considerable increases in the generation capacity and grid reliability of renewable power assets.[11] All of these factors contribute to investors having more predictable (and better, historically) returns when compared to other energy-related industries that are heavily impacted by the cost and revenue basis of oil and gas exploration and production, which have suffered greatly this year, in part due to the COVID-19 pandemic.

Finally, as has been well documented in recent years, there is over a trillion dollars available to be invested by private equity firms. Asset managers are looking for different asset classes that can produce quality returns and the power sector, with its anticipated growth in demand in the coming years, will likely remain an attractive area for investment.

## DISCUSSION

### I. Typical Investment Structure

For many asset managers, the “platform” approach to investing in the power sector may be a compelling area to explore.[12] This approach allows investors to deploy larger amounts of capital in a systemic manner and at scale and is therefore geared toward aggregating assets that will be attractive to secondary buyers (opposed to the approach of obtaining individual assets and selling them off one by one). A platform investment



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can take many forms in the power sector including (i) investing in the creation of a new platform with or without a particular geographic or asset class focus (known as “greenfield”), (ii) buying rights to a small group of existing assets under development, creating a platform and then adding new generation capacity (known as “buy and build”) or (iii) expanding existing facilities and platforms (known as “expansion and growth”).<sup>[13]</sup> It is important to understand the risks associated with any platform investment of a particular nature. For example, engaging in a greenfield investment can be more speculative as projects will likely need additional time for regulatory approval, which could slow or even make the project uneconomical. However, such investments arguably could present greater returns as they can potentially give investors more control as to how assets will be constructed and aggregated for an eventual exit. The key to any platform investment is identifying and partnering with a strong management team and other relevant counterparties (e.g., operators, consultants, etc.), each of which will need to be carefully diligenced as in any other traditional investment. Note that diligence considerations for counterparties vary widely based on the asset class (for instance, hydroelectric or nuclear generation assets will obviously be more heavily regulated than a micro solar generation facility), and while specific diligence considerations are not addressed in this article, we recommend engaging with advisors with local regulatory specialty early in the process in order to identify any possible foot-faults.

Another important consideration is the vehicle by which investors will provide capital. This can take the form of debt or equity (or a combination of the two). Debt investments present a more predictable, low-ceiling return as the amount of payments (including principal and interest) are fixed and there is an expected date when the debt must be paid off (i.e., the maturity date). Equity investments can be structured as traditional common equity (whether or not representing a control position) or preferred equity (which can be structured in many different ways and discussed in detail below). Given its capital priority, equity investments are necessarily more unpredictable and focus on generating greater returns to investors in an upside scenario. Funding through a combination of debt and equity could help offset the potential downsides either investment vehicle presents alone, and this can be achieved through careful structuring of the proposed investment. This structuring exercise will require tax, legal, regulatory and related advice, which specialist counsel can tailor to the unique circumstances of the proposed transaction.

Further to the considerations discussed above, there are specific considerations when financing an investment with debt. When contemplating financing a platform acquisition, it is important to build in flexibility and capacity under the operative credit document to allow for the financing of additional acquisitions down the road. This can come in the form of a robust incremental debt facility, a sizeable revolver, and “grower” components to the negative covenant baskets to allow the expansion of basket caps with the growth of the company group. Astute counsel will ensure a credit agreement includes these myriad provisions to allow asset managers and their portfolio companies to access readily available financing in the face of a fast-moving add-on acquisition and/or a highly competitive bid process. Knowing that financing can be efficiently drawn upon

from an existing credit facility ensures greater certainty in this very important facet of leveraged buyouts.

## A. Economics and Milestones

Once the type and general structure of investment has been identified, it will be important to establish clear milestones for when investors are obligated to fund any agreed commitment to the project(s). In the power sector, funding is typically provided in stages in any project involving anything other than the simple acquisition of existing, operating assets (following, of course, receipt of all necessary consents and approvals and other customary closing conditions). In a power transaction involving commitment for development or acquisition of future projects (or both), providing funding in stages will help investors get some protection from the uncertainty and risks involved with developing projects in the power sector. Examples of key milestones that should be considered include (i) obtainment of governmental approvals, consents, licenses and/or permits necessary to construct and operate the subject project, (ii) execution of an agreement with a pre-approved list of contractors to build the project, (iii) the actual commencement or completion of project construction, (iii) commercial agreements with customers (i.e. power purchase or “off take” agreements which can “lock-in” the expected project returns<sup>[14]</sup>), (iv) obtainment of the necessary real property interests to develop and operate the project and (v) completion of a system impact study. Note that, the complexity of the proposed project will drive the consideration of these and other milestones (for example, the construction of a fixed, non-mechanical project such as a battery storage facility is likely to be thought of as significantly less risky than the construction of a turbine-driven generation project). Further, defining these milestones will likely become a nuanced negotiation between the seller/developer and the investor (for example, a developer will want to limit a permit milestone to only discretionary permits as opposed to permits involving fixed standards, etc.).

The next area of attention will be defining the waterfall of distributions. Typically, investors will receive a preferred return threshold before management participates (reflecting IRR considerations). These can be calculated on a project-by-project basis or overall for the platform. Following the preferred return, management and other common investors will begin to participate, and we have seen allocations for management that vary in range significantly, usually based on achieving pre-agreed returns (for example, a 10% participation up to a threshold of overall equity value, increasing as equity value increases). Note that these are general themes only, and each investment will need an analysis of the quantum of cash expected to be generated and how that ties to the return and participation hurdles in an investment. Unexpected costs (caused by construction delays, damage to assets, etc.) can also impact whether any distributions will be made.

## B. Governance

When exploring an equity investment, certain governance protections and rights are important considerations, especially if a private equity investor will be investing in an existing project with an established management team or where there is not complete operational control. In these scenarios, the investor may hold a minority interest in the



investment vehicle (a “Platform Entity”), which in turn will own special purpose vehicles holding operating assets (not all of which may be subject to investment by the investor). It will therefore be important that the investor obtain customary approval rights to protect its investment. A key subset of the approvals with respect to material, senior equity investments that investors should seek include:

any amendments to the governing documents of the Platform Entity and similar governance limitations for its subsidiaries; issuance of any securities (including management incentive units or similar types of equity awards), which can be limited to senior to or *pari passu* with the securities held by the investors (depending on the overall magnitude of the investment);

- approval of expenses above a pre-agreed budget;
- declaration of bankruptcy;
- a sale or merger;
- any asset dispositions of a certain relevant size; and
- incurrence of debt of a certain size.

Admittedly, these several approval rights are common to many industries. Specifically for renewable power investments, additional approvals may include consenting to certain regulatory applications or disclosures, changes to the nature of the business, and ESG policies or reporting. Assuming a lack of complete control of the Platform Entity, depending on the level of involvement that an investor wants (and structure of the investment, i.e., whether debt is a portion of the aggregate investment), the ability to appoint board directors or just a board observer may be desirable. Apart from strict governance controls, an investor will also want adequate access to the financial statements and other customary information of the Platform Entity as well as its books and records (this should include, specifically, any material regulatory applications and construction permits). Other customary governance provisions that will be covered by the relevant documentation will include transfer restrictions and mechanics (the investor should be entitled to cause an exit, see further detail below), indemnification and waivers, anti-dilution mechanics and rights and protections relating to management’s equity.

## II. Exit and Further Investments

Exit strategy is important to all private equity investors, and investments in the power sector are no different. This will remain true despite the proliferation of open-ended investment funds with an infrastructure focus (including power), as investors in the funds will continue to seek some assurance of eventual exit and return of capital. In the context of renewable power investments, we have seen multiple structures designed to achieve some certainty around exit return realization and return of capital. For example, one way investors can realize returns following successful development is by purchasing projects outright from the Platform Entity once projects have reached certain milestones (some of which are discussed above), and then have absolute discretion on a subsequent sale of the completed project to a third party for a premium once they are completed, all likely subject to pre-agreed pricing and valuation mechanics allowing the

developer managing the Platform Entity to realize its own return thresholds. On the other hand, the investor and Platform Entity may agree that only a complete exit (by sale to a third party or IPO) will be permitted or agree to a purchase option such as a ROFO or ROFR. All of this will depend on the magnitude of the original investment and the goals of the investor, and will necessitate negotiations of appropriate purchase milestones, purchase price adjustments and other protections against known and unknown risks (casualty or condemnation of the project being the most commonly addressed). While this structure can be common in other industries, investors view it as optimal to implement in the power industry because of the easily identifiable milestones and how those are obtained through known cost inputs and expected earnings. Nevertheless, a valuation dispute resolution mechanic by an independent third party is recommended if an exit will not be solely in the control of the investor. Who controls the proposed exit will depend on the magnitude of capital invested.

### III. M&A Considerations

Assuming a project is acquired, we wanted to highlight the unique M&A considerations presented in the renewable sector from a risk allocation perspective as well as Platform Entity specific considerations. With respect to risk allocation, because the principal value in power deals is linked to physical assets, condemnation, casualty and risks related to construction are particularly important issues to maneuver, and may include: (i) addressing delays in construction or permitting, (ii) loss of or damage to assets, or (iii) impaired real property rights due to a government's exercise of eminent domain. All of these issues are potential concerns for investors in a project sale exit scenario in between the time of signing and closing. Sellers will be sensitive to investor attempts to shift the burden of these risks to them, but there are a number of ways that this can be dealt with beyond the blunt instrument of a construction milestone or closing condition. One way is to allow the buyer/investors to walk from the deal in the event that a condemnation, casualty or other material issue arises only if it is sufficiently material to only the project/deal (usually defined by actual dollar amounts equaling a certain percentage of the purchase price, and we have seen ranges going up to 30%).<sup>[15]</sup> However, since a walkaway remedy may be unpalatable to a seller in a competitive auction, other remedies include a purchase price reduction based on agreed monetary thresholds or post-closing indemnification or insurance solutions. For example, a purchase agreement could include an interim-operating period covenant that the seller maintains insurance on the project and any proceeds from the policy resulting from a loss of assets would be turned over to the investors/buyer at closing.

Another somewhat unique consideration with respect to power deals is the replacement of credit support. Companies in the power sector will often have posted credit support for the benefit of third parties, such as guaranties, letters of credit, bonds or indemnities. A typical seller request in a sale of a project will be that the buyer provide a replacement for the seller's credit support obligations prior to closing. However, fully replacing seller credit support obligations can be difficult for many buyers, especially private equity investors making an investment through a newly created SPV that do not want to tie up excess fund capital. A solution to this issue that we often see is the maintenance by the seller of its existing credit support obligations for a specified period of time post-close, with an indemnity provided by the buyer for any draws on the seller's

credit support obligations until the buyer can get its own credit support organized. In either scenario, a buyer should seek a representation regarding a complete and accurate list of credit support obligations to be replaced.

Permits are also an important aspect of power deals as they are necessary to commence construction and operation of a project. As discussed above, diligence and risk allocation will determine whether permits and any other government approvals necessary to construct, own and operate a project should be obtained prior to a sale being completed. In order to understand the scope of permits that are necessary (for example discretionary vs. non-discretionary permits), investors therefore should take care to diligence the specific laws of the jurisdiction in which the project will be constructed. An additional key diligence point will be any proprietary information or data analytics that the sellers have in connection with the project. In many situations, such data will remain the property of the sellers after the transaction, in which case, investors will want to make sure they have access to such information post-close (through the form of licenses and the like) to ensure they will have what they need for the continued success of the project. We are seeing substantially more attention given to proprietary data in renewable power opposed to traditional power generation, likely because of the technology innovation involved in the renewable power space. Continued success of a project will also require identifying any key employees through the diligence process. Certain individuals will be necessary to retain for the project to proceed successfully, especially when it comes to obtaining permits and other governmental approvals. The employees should either be a part of the acquisition or subject to a consulting agreement by which they provide professional services until the investors can replace them.

Finally, investors should also be concerned with subjecting the sellers to a non-compete agreement. Competition will play into the potential value proposition of a subject project, but competition with sellers who have an intimate knowledge of the purchased project would put a project at a serious disadvantage post-sale. Allowing the sellers to immediately enter into the market as a competitor will significantly and negatively impact the potential value of a purchased project and make it less attractive to subsequent third-party buyers. For these reasons, it will be important to obtain non-compete agreements to ensure that investors have the ability to capture the maximum value it expects.

#### IV. Other Diligence Considerations

A final note regarding the diligence expertise outside of M&A necessary to fully evaluate any potential investment in the power sector:

- **Regulatory and Governmental Relations** – To determine the specific governmental approvals necessary to construct, own and operate the project at issue. Given the magnitude and importance of the projects in question, particularly for investments outside of the U.S., government relations and corruption diligence should be undertaken.

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- Power Project Financing and Development – To review EPC contracts, development agreements and management agreements, especially when diligencing development of any greenfield project.
- Environmental – To evaluate any potential environmental related liabilities (including review of Phase I reports) associated with the project.
- Intellectual Property – To review any proprietary information necessary for the success of the project. Many developers or operators of renewable power assets will have (or have access to) proprietary IP with respect to the power generation capacity of a particular asset or other important data (e.g., wind analytics).

## CONCLUSION

We predict that more private equity investors will become involved in the power space, especially those with infrastructure and O&G experience.[16] This will likely be driven by the drop in oil prices, which implies lower returns, and the continuing (and increasing) global drive to create a low-carbon energy future. We hope this guide is helpful in assessing the practical considerations in the various common types of transactions we see in the space as we continue to help our clients in this unique investment sector

## Footnotes

- [1] Here's how the private sector can lead the global energy transition, published Jan. 1, 2020, by Jeffrey Martin (available at <https://www.weforum.org/agenda/2020/01/energy-transition-private-sector-climate/>).
- [2] A Primer on the Power Generation Business, by US Power Generating Company, page 2 (available at <https://www.easterngeneration.com/wp-content/uploads/primer.pdf>).
- [3] A “microgrid” is a compressed electrical grid that is able to connect with a larger, traditional grid, but also able to go into an “island” mode (i.e., power a single or small number of buildings) in the event of a larger power outage on the traditional grid. Like a traditional power grid, the source of power behind a microgrid ranges from fossil fuels to more renewable sources of power such as solar. See Why the majors, electric utilities, and private equity firms all want to own US microgrids, published Sept. 3, 2020, by Isaac Maze-Rothstein (available at <https://www.woodmac.com/news/opinion/why-the-majors-electric-utilities-and-privateequity-firms-all-want-to-own-us-microgrids/>) and What are microgrids and how do they work?, published January 17, 2019, by Spencer Fields (available at <https://news.energysage.com/what-are-microgrids/>).
- [4] See A Primer on the Power Generation Business, by US Power Generating Company, page 8 (available at <https://www.easterngeneration.com/wp-content/uploads/primer.pdf>) (noting that “for every one percent increase in GDP, electricity demand generally grows by about .7 percent.”)



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- [5] Private Investing in the Power Sector in Emerging Markets, published Oct. 2015, by EMPEA, page 14 (available at [https://www.empea.org/app/uploads/2018/02/PowerSectorReport\\_WEB\\_public.pdf](https://www.empea.org/app/uploads/2018/02/PowerSectorReport_WEB_public.pdf)).
- [6] As the focus on ESG continues to grow, some investors may be drawn to a private equity fund because of its commitment to invest in areas addressing ESG issues. (See Private equity firms power up investments in renewables, published Dec. 2, 2019, by Elisângela Mendonça (available at <https://www.penews.com/articles/private-equity-firmspower-up-investments-in-renewables-20191202>) (noting that Copenhagen Infrastructure Partners received \$700MM for a new fund to invest in renewable energy infrastructure). With this in mind, it will be important that funds maintain an ability to ensure that their investments remain in line with the ESG issues they sought to address when the investment was made. This will be important in order to keep investors happy. Some of this may be accomplished through oversight of the board through a board seat in an equity investment or limiting the ability of a Platform Entity to change its business with investor approval. Separately, for investments in existing projects, it will be important to evaluate at the outset whether the project meets ESG goals of investors, and if not, how much capital is needed to bring such project into compliance.
- [7] Directors, Take Note: ESG Can Drive Value in 2020, published Feb. 19, 2020, by Latham and Watkins, LLP, page 2 (available at <https://www.lw.com/thoughtLeadership/Directors-Take-Note-ESG-Can-Drive-Value-in-2020>).
- [8] What is ESG, and is it important in the energy space?, published Mar. 20, 2020, by Stu Turley (available at <https://www.oilandgas360.com/what-is-esg-and-is-it-important-in-theenergy-space/>).
- [9] ESG metrics continue to emerge as key criteria for power sector investment, published Feb. 13, 2020, by Fotios Tsarouhis (available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-metrics-continue-to-emerge-as-key-criteria-for-power-sectorinvestment-57087406>).
- [10] Why the majors, electric utilities, and private equity firms all want to own US microgrids, published Sept. 3, 2020, by Isaac Maze-Rothstein (available at <https://www.woodmac.com/news/opinion/why-the-majors-electric-utilities-and-privateequity-firms-all-want-to-own-us-microgrids/>).
- [11] Five Takeaways: What's New In Energy Private Equity? Trends and Developments in a Shifting Investment Landscape, published June 26, 2020, by Edward Zaelke, Christopher Gladbach and Seth B. Doughty (available at <https://www.mwe.com/insights/five-takeaways-whats-new-in-energyprivate-equity-trends-and-developments-in-a-shifting-investment-landscape/>).

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[12] See Why the majors, electric utilities, and private equity firms all want to own US microgrids, published Sept. 3, 2020, by Isaac Maze-Rothstein (available at <https://www.woodmac.com/news/opinion/why-the-majors-electric-utilities-andprivate-equity-firms-all-want-to-own-us-microgrids/>) (noting “in search of returns, some investors are continuing to take a greater amount of merchant risk or development risk than they previously would have accepted, and some investors are investing in platforms rather than projects.”).

[13] See Private Investing in the Power Sector in Emerging Markets, published Oct. 2015, by EMPEA, page 10 (available at [https://www.empea.org/app/uploads/2018/02/PowerSectorReport\\_WEB\\_public.pdf](https://www.empea.org/app/uploads/2018/02/PowerSectorReport_WEB_public.pdf)).

[14] This will vary by type, magnitude and connectivity of the project.

[15] See A Legal Guide to Power Generation Mergers and Acquisitions, published Dec. 2, 2018, by Jeff M. Dobbs and Robert S. Goldberg (available at <https://www.powermag.com/a-legal-guide-to-power-generation-mergers-and-acquisitions-2/>).

[16] See Why the majors, electric utilities, and private equity firms all want to own US microgrids, published Sept. 3, 2020, by Isaac Maze-Rothstein (available at <https://www.woodmac.com/news/opinion/why-the-majors-electric-utilities-andprivate-equity-firms-all-want-to-own-us-microgrids/>).

