



TRANSCRIPT

LegalMindsTV Exclusive Interview:

"Trends in Energy Company Finance, Post-Financial Crisis"

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Jeff, before we get started, can you tell me about the focus of your practice?

The focus of my practice at Pillsbury is the representation of underwriters and investors, mostly in connection with energy companies although I do work in other industries. My day job is principally the working in the energy area on the financial institution side. And what that means, this is a corporate finance type of function; securities, law, offerings, public and private securities.

Talking about what's been happening in the financial markets lately, the bankruptcy filing of Lehman was probably most significant, what kind of an impact has that had on the energy sector in terms of funding or other issues?

I think the financial crisis and in particular the Lehman bankruptcy from a year ago really hit energy companies in the same way that it hit companies in other industries. Principally, it was a wakeup call for treasury and finance folks to take a look pretty critically at their liquidity strategy, their capital structure, financing plans over the next year or two and try to think out of the box and go back to the drawing board and say, maybe we should think about things a little bit differently here given what's happened in the financial markets and that all revolved

around a type of cash or liquidity is king type of strategy. And a number of things fell out of that, whether it was cutting the dividend of a company, whether it was cutting down non-essential capital expenditures, whether it was involuntary and some times voluntary separation programs and other things that were all designed to preserve cash.

It seems that the markets are beginning to stabilize. How is that affecting financing and liquidity strategies in energy sector?

Several trends have occurred since the market has stabilized a bit this year after the Lehman bankruptcy crisis. There's a couple of those trends that I would talk about. One is, from a company perspective, most companies in the energy space went down – went back to doing back-to-basics secured financings as opposed to unsecured financings because that was the cheapest cost for them. At the same time, that played into investor appetite in terms of supply and demand type characteristics because those investors were looking for more flight to quality type investments and that played right into doing secured financings. I think the other trend that we saw in this past year after the financial crisis was that companies began to be proactive around their refinancing plans. What I mean by that is looking out to 2010 and 2011 rather than waiting until, let's say, debt maturities came due in those years, they were more proactive about going out this year and refinancing those maturities. And there is a phrase in the jargon that's called towers of debt and they were trying to reduce those towers without having to face in 2010 and 2011 no time - not knowing what the markets were going to be like in 2010 and 2011. I guess the last thing was around revolving credit facilities, that's not typical capital markets debt, but when expirations of those facilities were a year or two out, companies this year would look back and say, hey, let's go out now and try to renew those facilities because it will be a message to our investors, whether it's shareholders or debt holders that again we're safe from a liquidity perspective.

What are some of the other trends that you've seen and what does it mean for the future in that sector?

I think in terms of looking forward now, right now that the markets have stabilized and hopefully they'll continue to improve over the next year or two. What does that mean for energy companies? What are they now if they've stabilized themselves, if they've done the

things around cash and protecting themselves with refinancing towers and the like, what are they now looking towards in the next couple of years? I think the one constant for energy companies that's going to be true, no matter what the markets are, is that they are going to have to finance. They're finance intensive, capital intensive, capital-oriented type of creatures. And what does that exactly mean? When you think about the energy space, there is a variety of ways in which they're going to need capital. Whether it's aging infrastructure, particularly with generation facilities, whether that's coal or gas facilities that were built 40, 50, 60 years ago, whether they are trying to increase rate base, which is just a fancy way of saying how can we earn more money on the property that we build and that we invest in, particularly in transmission and distribution lines, lines that bring electricity into everyone's homes or whether it's trying to comply with environmental standards, which all you have to do is read the papers and see that those requirements are going to be more stringent and stringent. Companies are going to need financing. How do those companies deal with that? And I guess the way they deal with that is in one or two ways. They can continue to raise money in the debt and equity markets or their cash flows just from operations can support that. And I think it will be a little bit of mix of both, companies that have stronger cash flow metrics will be able to finance internally with less equity, which is usually a preference of companies not to dilute existing shareholders, at the same time companies with, let's say, weaker cash flow metrics will probably be in the capital markets both for debt and equity on a pretty regular basis over the next two or three years. And if I'm a CFO, I ask myself if that's my plan and my strategy, what if the markets tank again and what if the markets continue to be volatile, how do I deal with all that.

What are some of the strategies to deal with these issues, should the market continue to be volatile?

When I talk about "cash is king" strategies, there are a variety of ways in which companies could get cash out of their assets, out of the capital markets. The traditional ways some of it we talked about. For example, just going into the markets and raising debt or raising equity. Another one that's a bit more novel, particularly in the energy area, is the monetization of assets, which again is just a fancy way of saying how can I squeeze more value, more liquidity, more cash, if you will, out of assets that are typically inert and not susceptible to getting that value out of them in the normal. These are assets that have a tremendous amount of value. We

are talking about a transmission system, let's say, for a big utility or even a distribution system. Companies everyday now are trying to analyze with the help of investment banks how they can get that embedded value out of those assets, but somehow still maintain operational control. And there's a variety of structures and ways in which those assets can be monetized from selling them to third-party owners who bear the risk of ownership, but continue to outsource the operation of those assets to the utility who would run it, trying to do financings that are only secured by those transmission assets and not the rest of the assets of the company and just straight sales. We've seen in the last ten years, again using transmission because it really is the best example, some independent transmission companies in the United States, of which I think there is only two or three at this stage have cropped up, but those are companies that bought transmission assets from regulated utilities and that's their business model - run the transmission assets, earn a return on equity that's authorized by the Federal Energy Regulatory Commission and hopefully that will result in good returns not only for the shareholders, but also the other stakeholders, debt holders and the like.

How do these trends affect the advice that you give your clients?

In terms of advice that I give my clients in the energy space, whether it's underwriters or energy companies themselves, it can be summed up by saying "be prepared." We are in volatile markets, we're in uncertain times, you can't be stuck in a particular strategy, stuck in a particular timetable. From the perspective of what I do on a everyday basis that often means going to regulators and getting financing approval to do what you want to do, whether you are a Treasurer or a CFO or whether you are a banker who're advising these people. The two principal regulators are the Securities and Exchange Commission - registration statements need to be filed to offer securities. That's usually a pretty straightforward process. The more thorny process tends to be with local regulators when you need to go out and get financing approval to offer securities - that can be time consuming. It can some times be contentious, depending on the company's relationship with their regulator. And I guess the bottom line point that I always try to advise clients, which is difficult sometimes if you have an inflexible regulator, is try to get your financing orders to be as open-ended and flexible as possible. One of the things we saw last fall after the Lehman bankruptcy was there were some regulatory orders that had interest rate caps embedded in them, which resulted in companies effectively being locked out in the market because rates had skyrocketed at the time. So when you go out

and get regulatory orders within the bounds of political reality that you have to deal with at the regulatory level, try to be mindful of being as open ended and flexible as possible.

Have there been any recent changes in the regulatory landscape that have had an impact or that you anticipate having an impact on your clients businesses?

I think regulators are much more prone to be involved. I think for them, the financial crisis was a wake up call as well in that 20 years ago, ten years ago, even five years ago people thought about electric utilities - and regulators were probably in this group - as being boring conservative companies, somewhat stogy. But I think what the financial crisis proved is that nobody is immune or insulated from what happened in the financial crisis and it was just a question of degree. To bring it back to regulators, I think that meant that the regulatory needle was moved to the "more regulation" side of the equation so that companies now when they used to march in and ask for regulatory approval, ask for rate increases, ask for things - not that it was easy to get, but it was much more constructive. And now I think it's a much more of an adversarial relationship, especially when it comes to rates. Think about the times that we are in. We are in a recessionary time frame and regulators don't want to be going to their constituents, the ratepayers, and saying "guess what guys, your rates have gone up yet again." And so they have to balance the need for utilities to earn a return on what they are investing with the needs of their ratepayers to not see double-digit increases in their rates year after year after year.

Outside the traditional regulated energy companies, what else do see in the energy landscape for the year ahead, 2010?

In terms of outside of energy companies, the traditional utilities, other trends that I am seeing is in the alternative energy area, which is a big topic. But there is a regular and intense conversation that goes on around all the varieties of energy that would be characterized as alternative - wind, nuclear, solar, fuel cells, anything that falls out of the traditional" put the plug in the wall and get it from coal and the fossil plants would fall into the alternative energy category. And I think there are dozens, if not hundreds of companies over the last ten years, start-ups for the most part, that have raised seed financing to grow their companies, execute their business plan, build out their technology. And I just have the sense that in the next five

to ten years, those business plans have a few ways of going. They can either go to the next level or they're going to be acquired by somebody else or they're going to have to fold - and the principal reason for that is they're going to run out of money. And so the question is, will the IPO markets, for example, or other venture capital markets begin to open up in a way that really they haven't been for the last two years effectively. Will they open up in a way that's receptive to some of the more novel and successful business plans. If they do open up, I think we'll see alternative energy is being a big area that will play in that market. I am pretty optimistic about seeing that happen in 2010, at least may be towards the second half, but it remains to be seen.

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