Roundtable

US Energy

- FENGATE REAL ASSET INVESTMENTS
- HASTINGS FUNDS MANAGEMENT
- PARTNERS GROUP
- TEACHER RETIREMENT SYSTEM OF TEXAS

PHOTOGRAPHY: LEA RUBIN

Energy is the name of the game

Natural gas and renewables are the twin engines propelling US infrastructure's most dynamic market, four industry professionals tell **Bruno Alves**

There's an old adage that says US infrastructure is all about energy. But being old makes it no less true: in 2016, there is simply no other sector that comes close to providing the breadth of opportunities investors can find in energy infrastructure.

Some of the reasons for this are well-known. There is the shale revolution, which has arguably been key to the relative good health of the US economy over the last five years; there is the Environmental Protection Agency-mandated retirement of coal power, which last year saw 18GW taken offline, with cheap natural gas-fired generation stepping up to fill a large part of that vacuum; and finally there is the rise and rise of renewable power, propelled on the policy level by COP 21 and President Obama's Clean Power Plan and on the economic level by the crucial five-year extension of the renewables tax credits.

But while our participants – Fengate Real Asset Investments' George Theodoropoulos, Partners Group's Todd Bright, Teacher Retirement System of Texas' John Ritter and Hastings Funds Management's Rob Collins – are quick to agree on the plethora of opportunities offered by the US energy market, that does not mean the nature of those opportunities has remained static. In fact, compared with 2014, when *Infrastructure Investor* last held a US energy roundtable, a lot has changed.

"When oil was at $100 a barrel most of the midstream MLPs didn't have much of a need for private capital and mostly funded their growth through the public debt and equity markets," recalls Bright. "But the window for MLPs in the senior debt markets has got very tight and in fact almost closed at one point. I think they could still tap the public equity markets, but at valuations they wouldn't like so much."

"That's created an opportunity for us to invest in those MLPs at the holdco level through structured equity investments," he continues. "We also see an opportunity to carve out non-core assets from the MLPs or just invest alongside them at an asset level. All three of those opportunities are much more prevalent in a $50 per oil barrel world than they were in a $100 per barrel world."

Collins also sees good deals coming out of the changes in the MLP market. "I think when you look at how investment sentiment has moved away from just yield to growth in the MLP market, there's been an opportunity to pick off more meaningful midstream asset portfolios. Look at Enbridge's acquisition of Spectra. Two weeks prior to it, Spectra publicly said that it wasn't interested in selling discrete assets given low commodity prices – so instead, to maximize shareholder value, they just decided to sell the whole company. I think ultimately out of that combination will come further asset disposals for potential private investment."

"This is a great buying opportunity," agrees Ritter. "However, if you have a portfolio of midstream assets that you were hoping to sell at a high premium, this is not a great market for that."

Theodoropoulos, for his part, sees an opening in growing retail electricity prices. "We see retail electricity prices climbing over the next few years – that's the trend. The spark spread between retail electricity prices and natural gas is widening and that creates opportunity for a lot of inside the fence thermal-generated power – getting off the grid and generating your own electricity."

AWASH IN NATURAL GAS

With some of the headline changes out of the way, our conversation quickly turns to the key pillar of the US energy sector – natural gas. While the US is still awash in cheap natural gas that is increasingly becoming the preferred generation alternative, again not everything remains the same.

"Things have changed radically for gas over the past five years. It started out in the early 2000s in the Barnett shale and now we have the Utica and the Marcellus shale, which are home to an overwhelming majority of operating rigs. So all the new gas that is now coming online is coming from those two relatively new basins, but they are struggling with regional export capacity. It used to be that all of the gas was in Texas and then it got shipped up north; now we have the middle producing lots of gas, but it's kind of stranded there," Ritter explains. ››

AROUND THE TABLE

Todd Bright, head of private infrastructure, Americas, Partners Group
Bright joined Partners Group at the start of 2014. He is head of the firm's Houston office and of private infrastructure in the Americas. He is a member of Partners Group's private infrastructure investment committee. He has 24 years of industry experience. Prior to joining Partners Group, he spent six years as a managing director at Denham Capital working between London and Houston. Before this, Todd held a variety of US-based roles at firms, including Conectiv Energy, Statoil and Enron.

Rob Collins, head of global investments, North America & Europe, Hastings Funds Management
With over $135 billion of infrastructure transaction experience, Collins is also a senior member on the Hastings executive leadership team and the investment committee. Before joining Hastings in 2013, Collins was managing director, head of infrastructure for the Americas at Greenhill. He moved from Morgan Stanley in 2009, where he held the same title. He started his career in infrastructure M&A at Goldman Sachs.

John Ritter, director, energy & natural resources, Teacher Retirement System of Texas
As part of the ENR group, which targets commodity-related, inflation-sensitive assets, Ritter has underwritten over $5 billion in private equity investments, including reviewing over 100 direct and co-investment opportunities. Prior to joining the ENR group, Ritter led TRS' Other Real Assets group. He is also an adjunct professor at the University of Texas, Austin.

George Theodoropoulos, managing director, infrastructure, Fengate Real Asset Investments
Theodoropoulos joined Fengate in 2009. He is a partner and manages Fengate's infrastructure investment business. Theodoropoulous is also a member of the investment committee of the firm's infrastructure funds. Before his tenure at Fengate, he was a director with RBC Capital Markets and the head of its infrastructure advisory business in Canada. He also worked for CIT Financial Group with a focus on project financing of power and infrastructure.

> "We see an opportunity to carve out non-core assets from MLPs or just invest alongside them at an asset level" Bright

Much has been made of the US becoming an an overseas exporter of liquefied natural gas, but infrastructure investors expecting a raft of opportunities connected to LNG facilities should temper their enthusiasm.

"LNG export infrastructure is a pretty challenged sector right now," argues Bright. "Obviously, when oil was at $100 a barrel and European gas buyers were buying oil-linked gas and they were looking at Henry Hub that sort of arbitrage was looking pretty attractive. But that's changed now and we think there are a lot of headwinds for LNG export facilities here – not so much on the permitting side but more on the offtake side."

Some of those headwinds come from Australian LNG facilities that are now operational, Ritter points out. But that does not mean there are no opportunities to be had in the ongoing export shift. Just ask Collins, who netted a tidy sum when Hastings sold its stake in Texas's Freeport LNG to Global Infrastructure Partners in 2014.

"Initially, Freeport LNG was going to be an import facility. Then with the shale revolution we were able to turn it into an export facility and transfer the capital cost to third parties. We sold Freeport because the risk profile became very different – it became a construction risk play versus credit counterparty risk, which is what we were prepared to take. That situation turned out to be a very good monetisation opportunity, with north of a 40 percent return to our investors," Collins recalls.

Gas-fired generation continues apace, of course, but whether those opportunities are for your average infrastructure investor

or they require a more private equity-like risk appetite is up for debate.

"When I think of power I think, first of all, whether it's contracted or non-contracted. If it's contracted, I think natural gas and renewables can be a great opportunity. Unfortunately the returns there are not that high these days. But if you go for merchant-type generation, well, tell me what the price of natural gas is in the future and I'll tell you how exciting that is. Right now coal and gas are trading places in terms of being the low-cost provider of power. And what that has done is given us a really low and flat dispatch curve, which is bad for everyone in the business," argues Ritter.

Bright agrees: "A lot of the new-build gas we just mentioned is getting built on a quasi-merchant basis and we've stayed away from that except for one case where we invested in the mezzanine part of the capital structure rather than the common equity portion – that went well for us."

Collins, though, believes natural gas generation offers a strong set of growth opportunities for the strategic power investor. "What's been interesting is that you are now seeing multi-state utilities, such as Southern Power, actually buying gas-fired power plants in markets where they had no footprint, like Minnesota," he says, referring to the utility's recent purchase of the 720MW Mankato Energy Centre from power firm Calpine Corporation.

"To see one multibillion-dollar market cap utility find opportunity in that single asset purchase from another multibillion-dollar company tells you where they separately see growth coming from in this low interest rate environment. I think there is a trend now where strategics, such as our Southwest Generation portfolio company, are more actively evaluating buy-and-sell versus hold opportunities ," he concludes.

THE RENEWABLES REVOLUTION

You might have noticed that renewables have started to come up more and more in the conversation. That is not accidental. Once seen as an investment proposition of dubious merit due to the short-term nature of the Production Tax Credit and the Investment Tax Credit – the US tax incentives benefitting wind and solar respectively – everyone around the table pretty much agrees renewables are here to stay now.

The main reason for that, of course, is the five-year extensions of the PTC and the ITC, approved by Congress last year. "The extensions have given the sector a lot of stability because they now last for five years," says Theodoropoulos. "They used

> "There is a trend now where strategics are more actively evaluating buy-and-sell versus hold opportunities" Collins

to do them one year at a time which made renewables a tough market to invest in."

Some figures help illustrate the size of the opportunity: thanks to the tax credit extensions (worth around $25 billion), about 20GW of solar and some 19GW of wind power are about to be added over the next five years, according to *Bloomberg New Energy Finance*. That is a $73 billion investment opportunity at a time when the actual cost of installing wind and solar has dropped markedly.

"With the year-to-year fits and starts, renewables had been a roller coaster ride in the US for the last 10 years. That held us back from investing in renewables here when we were already investing in the sector in other parts of the world," says Bright.

There is just one problem with renewables: while they are clearly infrastructure, with none of the philosophical problems natural gas offers, they do not generate much of a return if taken as a vanilla play.

"It's tough to invest in renewables at the asset level – contract sizes are small, it's a lot of work and the returns on operating assets are low," says Theodoropoulos. "So while we've traditionally shied away from platform investing and development and operating companies, we're now looking at getting leverage from those teams that have their own capital, but are looking for additional money to increase their velocity in the marketplace."

Bright is also aware that fully contracted, long-term renewable assets are trading at single-digit IRRs and will not offer the kind of returns Partners Group is looking for. "We will look at assets with contracts from day one that protect principle, but if there's a recontracting element some 10-plus years out, we can look at those situations. Otherwise, we tend to go for premium returns by investing at the platform level," he offers.

While Partners Group will stop short of taking on merchant risk, Fengate's Theodoropoulos is happy to take merchant risk on solar. Maybe happy is the wrong word. "We do take merchant risk on solar, because you have to given the opportunities available, but what we do is to contract the SREC value," he explains.

For the uninitiated, Solar Renewable Energy Credits are a type of certificate available in states that have legislative requirements for a certain amount of solar energy. They allow investors to recover some of their investment by selling SRECs through the spot market or via long-term agreements.

"SRECs have an implicit floor, but that, in effect, is a merchant market. You can trade these certificates and go and contract with a utility that has to buy them over a 10-year period. What that effectively does is allow you to protect your project-level debt while your equity is effectively merchant. But it's nice to be merchant without a debt.

"This is a great buying opportunity. However, if you have a portfolio of midstream assets that you were hoping to sell at a high premium, this is not a great market for that" Ritter

KEEP DIVERSITY ALIVE

With the twin engines of natural gas and renewables propelling the US energy market, the stage seems set for a bright future. But there is one potential fly in the ointment: the highly controversial, highly polarising US presidential election.

As Ritter points out, with the others' agreement, a Hilary Clinton win will pretty much stay the course for US energy policy; it is harder to fathom what a Donald Trump victory might bring. Even with a Trump win, though, no one is expecting fundamental change to the market. As Theodoropoulos puts it, "there's a lot of balance in the system that doesn't allow for wholesale change".

Collins believes either candidate will probably end up being a "net positive" for private infrastructure investing: "I think that both sides realise that President Obama missed a real opportunity back in the global financial crisis, when he only spent $50 billion out of a $787 billion stimulus plan for shovel-ready infrastructure projects. Both candidates seem to understand that private infrastructure capital creates jobs and accelerates project delivery."

But it is Bright that captures the danger in the polarising environment created by the US election. "I hope, as a country, that we continue to adhere to an all-inclusive approach, as opposed to believing we have to choose between renewables or natural gas. The shale revolution has arguably been a real lifesaver for this economy over the last five years. So to cut against that part of the energy sector would be a big mistake. By the same token, I think renewables can be a huge growth driver for the country as well. I just hope we take a rational approach and stick with all of these sources." ■

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>
> **Theodoropoulos**