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Electric utilities eyeing gas assets; Kinder Morgan/Southern deal seen as example

Jim Magill
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A joint venture announced last week, in which Southern Company agreed to buy a 50% interest in Kinder Morgan's Southern Natural Gas pipeline system, represents a renewed trend of electric utility companies investing in natural gas assets, according to analysts.

In the Southern/Kinder Morgan deal, Southern said it would invest $1.47 billion in cash to create the new JV, while Houston-based Kinder Morgan would continue to operate the 7,600-mile gas pipeline system (see story in this issue).

“We're seeing a lot of acquisitions out there, and I think in many cases electric utilities are willing to look at gas infrastructure, particularly if it's perceived to have steady cash flow and earnings profile. I think that there clearly appears to be an appetite for it,” Paul Patterson, an energy analyst at Glenrock Associates, said in an interview.

In addition to the Kinder Morgan/Southern JV, Patterson cited as examples of this trend: Duke Energy's proposed $6.7 billion acquisition of Piedmont Gas and Southern Company's earlier acquisition of AGL Resources, which closed July 1.

In another recent deal, that also closed July 1, involving an electric utility and transmission firm acquiring a company that owns and operates gas and power utilities, Nova Scotia-based Emera announced the completion of its $6.5 billion acquisition of Albuquerque-based TECO Energy.

“We're seeing some more M&A,” Patterson said. He commented that there seems to be a desire on the part of companies that are primarily electric utilities to acquire companies that are basically gas utilities, or that have similar business profiles.

“A lot of these things aren't exactly utility properties,” he said. In the case of the Southern Natural deal, the JV revolves around the acquisition of a stake in a gas pipeline system, “but in many ways the pipelines have a utility feel,” Patterson said. “They're a little more structured and a little more stable than other investments.”

The current trend toward creating electric and gas combinations does not represent a new phenomenon, he said.

“In the ‘90s there was this big thing called convergence,” Patterson said. “Remember Duke Energy bought the old Panhandle. Then they spun it off later. Dominion, which was basically an electric utility, bought CNG.”

In addition, there has been a long tradition of consolidation of the electric and gas industries at the level of local distribution companies.

“It's not unusual to see an electric and gas company combined on the utility side,” Patterson said. “It's very common for a utility to have ‘electric' and ‘gas' in its name. The two often go together.”

What distinguishes the current merger trend from those earlier combinations is that large electric utility companies are now reaching further back along the natural gas supply chain to acquire unregulated gas assets, which could provide the electric utilities more opportunities for growth.

He pointed to the formation of a joint venture involving Florida Power & Light and gas producer PetroQuest Energy to produce natural gas from the Woodford Shale play in Oklahoma. FPL had hoped to include the cost of that deal in its rate base, but in May the Florida Supreme Court disallowed that inclusion, potentially reducing the incentive for power utilities to acquire E&P assets in the future.

“We should draw a distinction between pipelines and regulated gas utilities, and there's a big difference between those two things and E&P,” Patterson said.

The Southern acquisition of 50% interest in the SNG system on the other hand “seemed to be a little more opportunistic,” Patterson said. “In this case, it was them being a large customer and they saw this as a unique opportunity that the Kinder Morgan asset provided,” he said.

“As a regulated utility you don't need to buy the pipeline or the E&P,” Patterson said. “At the grocery store you don't need to own the farm.”

BMO Capital Markets' managing director, Michael Worms, who predicted more convergence among gas and power companies in a report last September, said the trend of electric utilities buying gas utilities is likely to continue.

“We think there's more to come,” he said in an interview. The need to expand through acquisitions is especially felt by a pure utility company, for which there is only one avenue for growth.

“If you're a utility company you need to grow from your rate base and get your earnings from that. But, if you've got other businesses, similar business, you've got options,” Worms said.

“One business may not be growing quickly, and then maybe another is growing faster, so they kind of offset each other,” he said.

Another driver of the trend for electric utilities to acquire gas assets is the rising demand for gas-fired power generation, as power companies retire aging coal plants.

“The switch to natural gas is part of the environmental push that we're seeing right now,” Worms said. He pointed to the Environmental Protection Agency's adoption of the Mercury and Air Toxics and Cross-state rules as giving electric utilities the incentive to move away from coal-fired generation and toward cleaner-burning gas.

“Now we have the proposed Clean Power Plan. In the meantime, companies are voluntarily shutting down coal plants,” Worms said.

However, Michelle Foss, chief energy economist at the University of Texas at Austin's Bureau of Economic Geology, said whether or not the trend of electric utility companies acquiring gas assets continues is entirely dependent upon the utilities' ability to pay to acquire the assets.

“Midstream asset owners need fresh capital but few utilities have the ability to make large acquisitions or even cover substantial joint ventures. Worldwide, the utility industry is in terrible financial shape,” she said in an email.

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