ANALYSIS > ENERGY YEARBOOK 2024

On the horns of a trilemma

As energy transition, security and affordability become ever-more urgent, the market is surging like never before. Alex Ryan

asks power pundits for their views on whether the purple patch can last.

21 March 2024 14:00pm

Alex Ryan

Energy Energy Yearbook 2024

For close to two years now, energy sector commentators have spoken of a 'trilemma': a struggle to balance the three competing imperatives of energy transition, security, and affordability. Of these three, energy transition arguably looms largest. For John Dewar, project, energy and infrastructure finance partner at Milbank and *Legal 500* Hall of Famer for power: 'The push to the energy transition has been the most disruptive change in the energy market in decades.'

Security and affordability entered the lexicon after Russia's invasion of Ukraine, reshaping attitudes towards the future of oil and gas resources. Add to this the continued development of novel technologies from carbon capture and storage (CCS) to green hydrogen, the shift to a higher-interest-rate and higher-inflation economy, and sweeping changes to regulation around the world, and energy lawyers have a lot to think about.

Fundamental changes

Baker McKenzie energy, mining and infrastructure group head Richard Blunt is clear about the demands of the transition: 'In order to achieve net-zero by 2050, we have to fundamentally change the way our society operates. An adjustment on the scale of the industrial revolution needs to take place between now and 2040 in order to give us the chance of achieving net-zero across the world economy by 2050. That requires regulatory movement, but more fundamentally it

requires massive change in terms of infrastructure development, energy generation and carbon reduction.'

Given this backdrop, it is unsurprising that, without exception, market commentators highlight the high and increasing volume of work relating to transition. 'Our management sees energy transition as one of the key drivers of growth for the coming years', says James Pay, head of the global renewables group at Clifford Chance (CC) and a *Legal 500* power Hall of Famer. 'I have no doubt that we'll be investing in the coming year. And we have no doubt that our competitors will continue to do so too.' The importance of energy to CC was illustrated when the firm opened an office in Houston in June last year. In London, too, in September, it hired project financing partner Craig Nethercott from Latham & Watkins.

Demand for energy and infrastructure partners in London remained strong throughout 2023. The biggest moves came in January, when infrastructure transactions specialist Sara Pickersgill left Allen & Overy for Kirkland & Ellis in a hire announced in September 2022, and energy and infrastructure duo Jessamy Gallagher and Stuart Rowson left Linklaters for Paul Hastings. Gibson Dunn built its practice in July when it hired Ben Shorten and Trinh Chubbock from Shearman & Sterling. Other Shearman departures in the sector included John Inglis, who went to Dentons as a consultant in May, and Julia Derrick and Sanja Udovicic, who moved to Ashurst in the same month.

> ‘An adjustment on the scale of the industrial revolution needs to take place between now and 2040 in order to give us the chance of achieving net-zero across the world economy by 2050.’ *Richard Blunt, Baker McKenzie*

And lawyers expect firms to continue to expand in the practice. In part this is because the scale of the work creates opportunities for large cross-practice teams. ‘We’ve seen a big increase in interest in energy transition projects in carbon capture and storage and hydrogen’, notes Slaughter and May corporate partner and *Legal 500* infrastructure M&A and acquisition financing Hall of Famer Hywel Davies. ‘Those are multi-practice projects, in that they typically involve project development work for our projects team, financing for our finance lawyers, and often a corporate element.’ Firms are keen to trumpet their capabilities to advise on these novel technologies, while clients are quick to highlight their investments. By contrast, wind and solar are less high-profile, as lower costs and technological improvements have left work in these areas more commoditised, while more ambitious projects struggle to get off the ground due to increases in both supply costs and the price of debt.

But investment in oil and gas remains significant. And oil and gas companies remain key clients for many firms, even as they adjust their businesses to the needs of a changing world.

Slow burn away from oil and gas

'There's going to be ongoing activity in the oil and gas space, because there's a growing recognition that we still need that sector', says Alex Msimang, energy M&A partner at Vinson & Elkins. 'A year ago, the person on the street's view was that we'd just stop using oil and gas. But now there's a recognition that we do still need it, albeit in a more carbon-efficient way.'

DLA Piper disputes partner James Carter agrees: 'The focus on decarbonising was arguably diluted last year as geopolitics caused there to be an increased focus on energy security. 2024 seems likely to see an uptick in focus on decarbonisation as compared with last year. Following COP28 that will hopefully see increased recognition and support for the critical role which oil and gas businesses can play.'

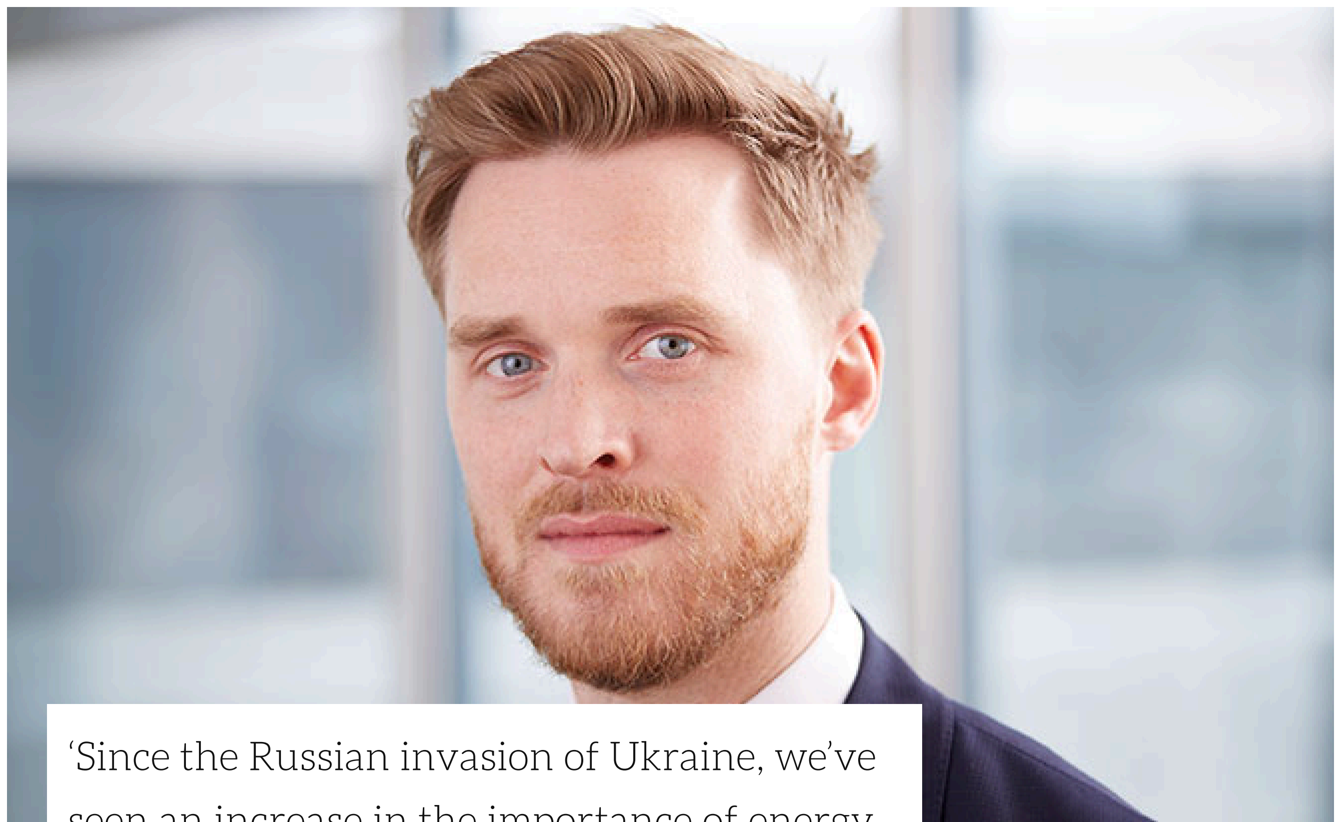
Above all it was the Russia-Ukraine war that triggered this widespread recognition of the importance of conventional power sources. Dublin-based Dentons energy partner Colm Ó hUiginn notes: 'Since the Russian invasion of Ukraine, we've seen an increase in the importance of energy security, which has enabled financing for natural gas and LNG infrastructure in particular.'

Dewar concurs: 'Gas is important as a transition fuel, LNG especially, with particular appetite for projects in the Middle East and Asia.' Liquefied natural gas (LNG) is an important part of the picture. Where conventional gas must be pumped through pipelines, LNG moves by ship. Countries therefore need far less infrastructure to secure supply: either an onshore LNG terminal or a floating storage and

regasification unit (FSRU), from which LNG can be pumped directly into the grid. With lower carbon emissions than both coal and oil, LNG is also appealing in the context of energy transition.

But even as concerns about energy security buoy their conventional offerings, oil and gas companies remain subject to the demands of transition. 'Oil and gas companies are looking for scale in particular', says Msimang. 'There can be more efficiency in terms of reducing scope 1 and scope 2 emissions by having it done by a few big companies rather than by many small ones. That's what the industry is doing. What that means for energy-focused lawyers is more M&A and joint venture (JV) activity.'

Davies makes a similar point: 'Upstream oil and gas has been affected by the subdued M&A market. But there have been some notable exceptions. Chevron's acquisition of Hess and Exxon's acquisition of Pioneer in the US in particular were huge. There's a possibility that this sort of activity will prompt further consolidation. Those deals are really about buying in large-scale production and driving synergy benefits to reduce costs.' The Chevron-Hess deal was valued at $53bn, with Paul Weiss acting for Chevron and Wachtell advising Hess. ExxonMobil-Pioneer had an even bigger ticket, with Exxon paying $59.5bn. Davis Polk advised Exxon and Gibson Dunn advised Pioneer.



'Since the Russian invasion of Ukraine, we've seen an increase in the importance of energy security, which has enabled financing for natural gas and LNG infrastructure in particular.' *Colm Ó hUiginn, Dentons*

There are still mega-mergers to be done, then. But conventional power investment faces pressures too. 'Even with the imperative of energy security, most countries in the OECD have 2050 net-zero targets, and in order to comply with these targets investments have to have a shorter time-horizon,' says Ó hUiginn. 'Providing 25-year debt to a project may potentially push a bank that is subject to a net-zero target past that 2050 mark, which makes it challenging for them to provide long-term debt to a project that has a fossil fuel component. This increases the attractiveness of decarbonisation options like carbon capture bolt-ons, to align with net-zero targets.'

And, as Davies notes, some companies have suffered after making transition investments: 'The European majors have made greater investments in transition than their US peers. They've been somewhat hammered for that in their stock price, where investors have been

rewarding the companies that have achieved higher returns. This has led to a bit of a shift from companies like Shell and BP. We might see less growth in capital investment in energy transition from the majors than we might have expected a year or two ago.'

Finding the financing

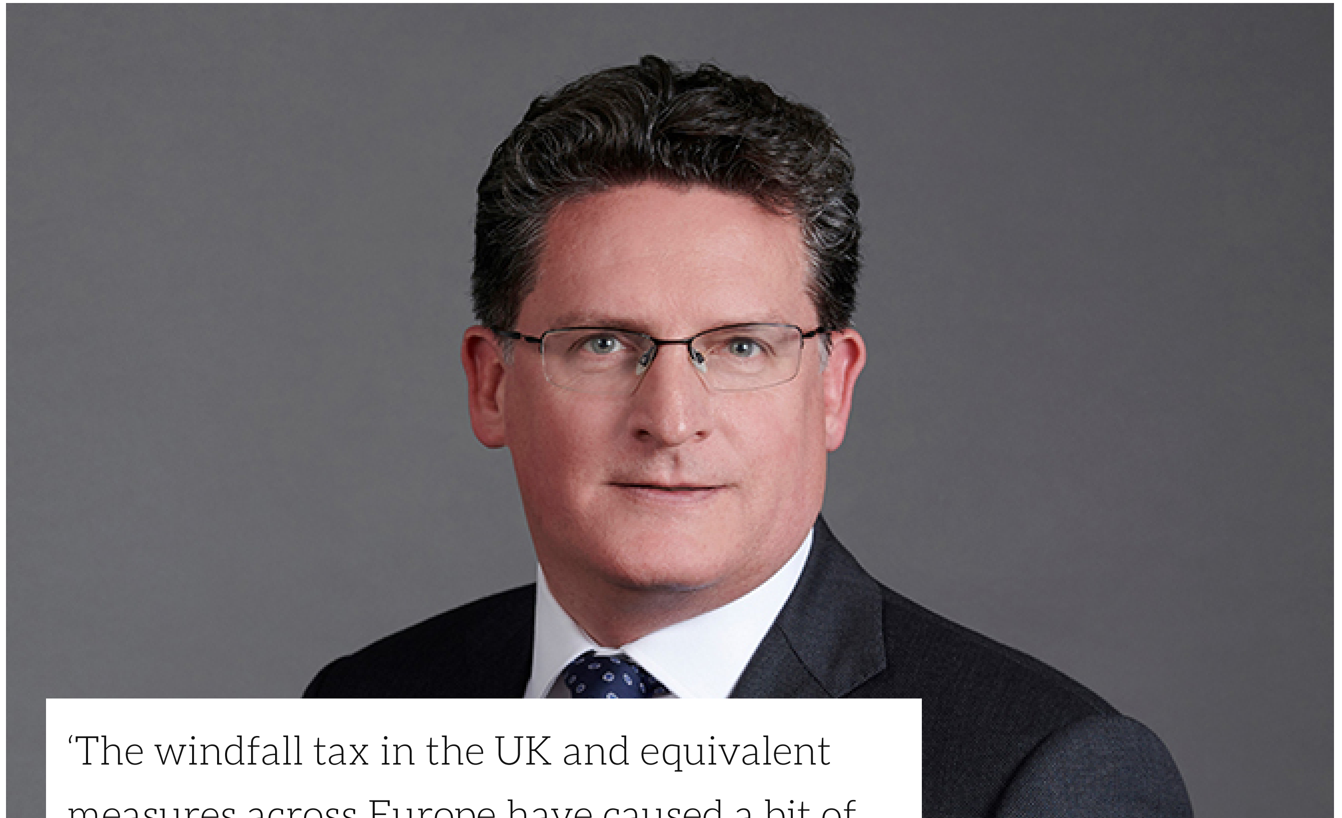
'A huge amount of funding will need to be deployed to meet energy transition and decarbonisation objectives', says Matthew Brown, a partner in Milbank's global project, energy and infrastructure finance group who joined the firm's London office from Latham & Watkins in May 2022. 'It's in the trillions of dollars.'

And while the energy sector has remained, according to Ó hUiginn, relatively buoyant, it is not immune to the economic pressures that have seen transactions slow around the world. Says Davies: 'We've seen a bit of a chilling effect in the UK and Europe, with high interest rates and inflationary pressures on cost resulting in a couple of failed renewables auctions.'

Still, there are positive indicators. The Bank of England has held interest rates steady at 5.3% since August 2023. And while consumer price index (CPI) inflation ticked up marginally from 3.9% in November to 4% in December, it remains well below its October 2022 peak of 11%. Natasha Luther-Jones, international head of sustainability and ESG and global energy and natural resources sector co-chair at DLA Piper, sounds an optimistic note: 'Inflation dropping in 2024 should, at a high level, improve the M&A and funding landscape with a lower-interest world opening the door to more capital and fundraising.'

Where the money comes from is also changing. Oil and gas supermajors remain valuable as co-investors, with many pointing to

an uptick in JV activity in areas like carbon capture bolt-ons. But partners also note that, without the gigantic balance sheets that oil and gas majors have, energy transition and renewables companies must turn to other sources of funding. 'Financing structures have had to change significantly to account for the unique aspects of these projects – including to address technology and offtake considerations', notes Brown.



'The windfall tax in the UK and equivalent measures across Europe have caused a bit of fallout in the oil and gas sector. A number of companies see the UK as a far less attractive place to invest.' *Hywel Davies, Slaughter and May*

This has created opportunities for private capital in particular. 'Private credit has been a big new entrant', Brown continues. 'There are now a very large number of entities that have raised multiple funds that are sizeable and aimed squarely at deployment across the energy transition sector.'

However, as Msimang notes, private investors may have less incentive to actively support transition: 'private investors are less subject to ESG pressures than many public companies are.' Pay makes a similar point: 'It's interesting to see that renewables funds, which were raised and were very successful, have been superseded by broader energy funds.' Few in the market expect this trend to reverse, even as corporates shift to greener modes of operating. 'A large part of portfolio reshaping is people looking to shed older and dirtier assets', says Davies. 'We'd expect those to go into private hands, where owners are a bit less in the public eye, and may be a bit more able to find ways to make money off those assets.'

A bumpy road

The energy market is active, then, and there is little reason to expect things to materially slow down. A contributing factor to this is the rising tide of regulation around the globe. 'There are a number of clients which would not usually be talking to us coming in and saying, we need to have an understanding of the energy space and how it works', comments Blunt. 'That's true in Europe and even more so in the US, where the Inflation Reduction Act is driving a lot of investment from people who wouldn't normally be interested in energy. There are a number of quotes out there from big US investors saying things like "we don't believe in climate change, but we do believe in the money to be made from investing in the energy transition"'.

Here, as ever, the competing incentives of transition, security and affordability can conflict. When energy profits soared across Europe in the wake of Russia's invasion of Ukraine, for instance, many countries responded with windfall taxes. But, argues Davies: 'The windfall tax in the UK and equivalent measures across Europe have caused a bit of fallout in the oil and gas sector. A number of companies

see the UK as a far less attractive place to invest. This is really a global business, so people have a choice about where they put their capital.' In this context, countries must ensure they remain desirable to investors. For Brown, European efforts to encourage investment have been driven by the desire 'to match what has happened in the US and to keep a competitive landscape for European projects.'

Pay, meanwhile, turns to the lesser-discussed third horn of the trilemma – affordability: 'It's only a year ago that we were talking about energy poverty and concerns around people being exposed to energy price hikes, and particularly the impact that would have on, not just the least wealthy people in society, but on businesses too. Those issues haven't gone away. We've got a bit used to higher prices, and we haven't yet had a winter energy spike in the way we did a year ago. But the exposure to that is something that there remains a lot of sensitivity to.'

And potential political changes mean the future of regulation is far from clear. 'There are a number of major economies having elections in 2024', says Ben Higson, London corporate practice head at Vinson & Elkins. 'It's difficult to know the direction of travel. It's possible we'll see a bit of divergence between Europe and the US.' Even this, though, 'may create some opportunities.'

> 'With changes to policy aims and outcomes having become far more common in recent years, managing those changes has become a more standard practice, which reduces concern around election-year change.' *Natasha Luther-Jones, DLA Piper*

Many are optimistic about the prospect of a change in government on this side of the Atlantic, with some anticipating greater consistency of policy after a spate of short-lived Conservative premiers. Others point to positive signs that Labour will not seek to rescind licences for oil and gas or to row back on investments in nuclear, CCS and hydrogen. 'People are fairly confident about things that are approved and underway', says Davies. 'It's the things with a longer lead time that are going to be subject to that paralysis that comes around every election where people just have too many doubts about regulatory uncertainty.'

Lawyers are less sanguine about the US election. Davies continues: 'In the US, you've got a really stark contrast in policy between the Biden

government and what a Trump government would bring. Even if not Trump, the Republican approach is likely to be far less supportive of policies like the Inflation Reduction Act that have been driving energy transition investment in the US.'

Overall, though, as Luther-Jones summarises, clients in the sector are increasingly willing and able to take regulatory change as a given: 'Managing interventions through regulation and policy was historically a big worry for clients. With changes to policy aims and outcomes having become far more common in recent years, managing those changes has become a more standard practice, which reduces concern around election-year change. We'll increasingly see longer term contracting account for changes such as price caps or tariffs in the interim.'

Of course, there is always scope for unexpected threats to rear their heads. Several lawyers pointed to conflicts in the Middle East, with Houthi activity in the Red Sea already disrupting shipping. But, again, there is no sense that this will produce a slowdown. Rather, as Msimang notes: 'Projects sited elsewhere will become more significant. If you're an energy investor, something like a West African LNG project now looks very attractive, as you can help ensure supply to Western Europe and the Americas without worrying about geopolitical tensions in the Middle East.'

As Blunt concludes: 'It'll be a bumpy road. The world is an increasingly polarised place, and that can result in short-termist decisions being made. Perhaps I'm just a bit of an optimist, and can't quite face the idea that by the time my kids grow up the world will be a bit of a mess, but I think we will get there. The hurdles are present, but I believe they will be overcome.'

alexander.ryan@legalbusiness.co.uk