Picking Up A Live Wire:
Why Energy Issues Should Be Included In Your Due Diligence
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Reliable energy supply is critical for a wide variety of entities, whether they are industrial and manufacturing operations, commercial office buildings, large retail centers, or institutional facilities, such as hospitals and schools. Additionally, energy costs are generally a significant line item for all these types of operations, and opportunities to control the "energy spend" are important. Beyond the basic rate paid for electricity or natural gas, there can be less obvious energy-related risks and costs-as well as opportunities-with alternative supplier and utility contracts, on-site generation, energy efficiency programs, demand response, and other energy strategies. These risks and opportunities--already relatively complex--are likely to multiply in light of the recently finalized but yet-to-be implemented federal Clean Power Plan. Simply put, energy issues should be a primary consideration when companies are evaluating potential acquisition targets.

This article highlights some key considerations in determining whether to include energy issues in your due diligence protocol, with an eye toward identifying costs and risks, as well as maximizing savings and opportunities.

Contracts with Alternative Suppliers

In states with competitive or "deregulated" energy markets, customers can contract with an alternative supplier other than the public utility for the **supply** of electricity and natural gas. The equipment used for the delivery of the electricity or natural gas - i.e., the electric wires and gas pipes--continue to be owned and operated by the utility, which continues to charge for the **delivery** portion of the service.

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Depending on market conditions, a customer may achieve significant savings or other benefits such as price stability by contracting with an alternative supplier. Of course, it is important to ensure that arrangements with the supplier are sufficiently defined and fair. This evaluation is also important as an element of due diligence in evaluating a target for acquisition. So, how can an organization that may "stand in the shoes" of the acquisition target evaluate risks and contract value? The following questions provide a good place to start:

- Does the contract provide service to meet 100 percent of the customer's need on a firm, non-interruptible basis, or are supply curtailments or interruptions permitted (in exchange for a lower price)?
- Does the contract provide for a "fixed" price or a "variable" price that can change by the hour, day, or month?
- Even if called a "fixed" price, can the price be adjusted based on specified legal, regulatory, or market changes? Not all "fixed" prices are the same-does the price include regional energy market charges, "capacity" charges, and similar variable costs?
- Does the contract accommodate energy efficiency, demand response, and installation of on-site generation?
- What events will lead to early termination charges? How are those charges calculated?
- What are the assignment rights, and do the economics of the contract dictate that the acquiring entity accept assignment, oppose assignment, or seek to renegotiate terms as a condition to assignment?

The due diligence period can also be viewed as an opportunity, not only to understand the target's alternative supplier contracts, but also to revisit the acquiring entity's supply arrangements. For example, the acquiring entity should evaluate the target's procurement strategy to implement "best practices" for each entity, and determine whether savings can be achieved by consolidating contracts with a single alternative supplier. Also, consider whether there are opportunities to implement energy efficiency measures. Many utility programs provide financing for energy efficiency programs, and, depending upon the way in which a particular state chooses to implement the federal Clean Power Plan, additional funding may become available for such projects.

Contracts with the Utility

A target entity, particularly a large energy user, may have contracts with the utility responsible for delivering electricity or natural gas, regardless of whether the target is located in a state with or without a competitive market. These "special rate" contracts may provide a significant discount. Therefore, understanding the terms and conditions of a target entity's special rate, particularly the assignability and termination clauses, is an important aspect of due diligence.

On-Site Generation

On-site generation, as the term suggests, involves the installation of electric generation equipment on-site or close to the point of use. Traditionally, on-site generation was installed as backup generation to increase reliability or as "cogeneration" where there was a process that used or created heat or steam. Today, additional justifications may exist. Facilities may install on-site generation to save money (when generating on-site power is cheaper than taking power from the grid), to generate revenue (either by selling power back into the grid or using on-site generation to meet "demand response" obligations directly with a utility or third party), or to "go green." Additionally, the increased development of "microgrids," together with the decreasing cost of various renewable sources, suggests that deployment of on-site generation will increase significantly in coming years.

Due diligence regarding a target entity's on-site generation assets should include the following questions:

- Who owns/operates the on-site generation system (the target or third parties)?
- Is the on-site generation asset included in the transaction?
- What is the status of the feedstock contracts?
- What is the regulatory status and compliance obligations of the generation asset?
- What is the condition, useful remaining life, and O&M costs of the generation asset?
- Are there plans to modify or expand the generator and would those plans change the acquiring entity's
- regulatory status?

Conclusion

Changes in the energy world are rapidly accelerating on technological, legal, regulatory, and market fronts. The changing landscape presents risk to the uninformed, but also new opportunities for competitive advantage and innovative operations to the well-informed. Including energy considerations in your due diligence may not only mitigate risk, but also allow your organization to identify new ways to operate more efficiently and economically.