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Blue Wave Implications on Energy

There has been much speculation about the prospect of a "Blue Wave" and its resultant impact upon the Energy and Power industries, which are large sectors within the US High Yield and Leveraged Loan markets. Given the high likelihood that the Democratic Party will have swept Congress and the White House following the Georgia run-off elections, Alcentra's Senior Vice President Andrew Fahey, a specialist in Energy and Power, shares his views.

With President-Elect Biden in the White House and Democrats holding majorities in the House and Senate, we expect policies addressing climate change to be a central platform of the new Administration's agenda. This is expected to have meaningful implications for the Energy and Power sectors, which constitute ~17% of the High Yield and ~6% of the US Leveraged Loan investment universe. However, given that 6 Democratic Senators will represent some of the top fossil-fuel producing states in the nation (PA, WV, NM, CO) and the Supreme Court's conservative tilt, we do not expect dramatic, sweeping changes to the nation's energy landscape, such as a ban on fracking. We expect the Administration and Congress to take a "touch all the bases" approach. We do not expect dramatic restrictions on fossil-fuel usage but do expect heightened regulation. We also expect substantial public spending and other government influence to be directed towards growing renewable energy's market share vis a vis fossil fuels. Below we address some potential agenda items and their impact on HY Energy and Power sectors.

- **Potential $2 trillion Clean Energy spending plan.** The broad objectives are to decrease U.S. net-carbon emissions to zero by 2050, make the U.S. power grid "carbon-free" by 2035, weatherize buildings/homes to be more energy efficient, invest heavily in public transportation, and promote electric vehicles. While lacking in detail we view the plan as broadly negative for oil consumption but a near-term neutral-to-positive for natural gas consumption. Having enough electricity to meet the EV and public transport objectives will require that natural gas continue to be a meaningful component of the energy supply over the next 5-10 years. If electric vehicle sales grow faster than new wind/solar assets can come on-line demand for natural gas will have to increase in the near-term. Longer-term this is clearly negative for both oil and natural gas as net-zero carbon emissions by 2050 will require a large percentage of the U.S. energy supply to come from wind, solar, and other renewable assets. We expect more debt issuance from the Power sector over the coming years to fund more wind, solar and other renewable asset build-outs, though we acknowledge that carbon-related energy usage will remain a material source.

- **Presidential Executive Order: Moratorium on new leases and new drilling permits on federal lands/waters**. Oil production on federal lands and waters constitute ~20% of the nation's output. The impact will be minimal in the near-term as a moratorium does not affect existing leases, wells, or permits. In the medium-term it could be a modest positive for oil prices as it could limit supply. It is a clear negative for those energy credits with exposure to federal lands/waters but those producers have been pro-active in obtaining as many permits as possible under the current administration so they will have a sizable backlog of drilling permits to work through. HY and loan exposure to federal lands/waters is limited as super majors (IG-rated) are the major players in the Gulf of Mexico (the largest federal oil production jurisdiction). We estimate ~10% of HY and Loan Energy credits have some of their cash flows exposed to federal lands/waters.

- **A reconstituted Federal Energy Regulatory Commission could have implications for new pipelines**. The FERC is composed of five President-appointed commissioners. The FERC has final say on all interstate energy pipelines (and all interstate energy commerce more broadly). Interstate pipelines are already very hard to get built as there is often local opposition – add in federal opposition from the FERC and we could see little to no new pipelines being built. We view this as a positive for existing interstate pipelines as their "incumbent status" becomes more valuable. Midstream (pipeline-based) companies are a material component of the Energy investment universe. ~40% of HY Energy and ~90% of Loan Energy credits are midstream companies.

- **Ending favorable tax-treatment for Master Limited Partnerships**. Many HY midstream energy companies are organized as MLPs. Similar to REITs they do not pay corporate income taxes but are required to distribute most of their cash flow to unit holders (and then taxes are paid at the individual level). We view this as a potential positive for HY midstream companies as we have found the MLP structure forces companies to prioritize dividends when their cash flow doesn't necessarily support it. MLPs also have weak corporate governance as compared to C-Corps and we would like to see this change.

We believe these agenda items will have nuanced impacts across the Energy and Power sectors but will not result in a step-change in the U.S. energy mix in the near-term. Energy and Power companies have been planning for this "Blue Wave" for at least a year now and have taken steps to mitigate and/or take advantage of these potential agenda items. We see strong alpha-generation opportunities ahead created by credit dislocations that emerge from the market digesting the impact on the Energy and Power sectors.

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