

## Research and Insights

### Energy transition series: Gas LDC networks, is the future renewable?

December 2020

In a series on energy transition and the world's investible infrastructure assets, Ausbil's Global Listed Infrastructure team answer questions on energy transition, carbon and climate change, opportunities in infrastructure, and how infrastructure is meeting the challenge. In this note, we focus on state and local gas networks, a potentially exciting early stage investment into the future renewability of an old technology.

#### Q: What are gas LDCs and why are they Essential Infrastructure?

**A:** Gas LDCs, or local distribution companies, are regulated utilities that own and maintain pipelines that deliver natural gas to consumers, mostly residential. These assets qualify as essential infrastructure given that they are typically regulated, display monopolistic characteristics, have high barriers to entry, and deliver stable and predictable cash flows across the economic cycle. 'Gas LDC' is a term more commonly used in the United States with the more generic term 'gas distribution' typically used outside of the US – both describe the same assets. The following companies are examples of what we would call listed pure-play gas LDCs: Atmos Energy (NYSE: ATO), ONE Gas (NYSE: OGS) and Italgas (BIT: IG).

#### Q: Can you give us the elevator pitch on energy transition, what it is and why it matters?

**A:** The world has long relied upon fossil fuels, fuels that are typically mined (coal) or drilled (oil and gas), then burned for energy conversion either through combustion engines for propulsion, or in furnaces for the powering of electricity generators. The carbon intensive nature of fossil fuels has contributed to climate change, and other detrimental environmental and health consequences.

The world has generally decided that we have burned enough fossil fuels, and bodies like the United Nations have set targets for the transition to new types of cleaner and renewable energies: nuclear, wind, solar, geothermal, hydrogen gas, and carbon capture, utilisation and storage (CCUS) amongst the many examples. The Paris Agreement seeks zero carbon emissions by 2050.

The capital-intensive nature of fuel development and conversion along the entire value chain means that the transition to full renewable energy may take many decades. While more and more Governments are signing up to a 'net zero by 2050' target, few have a detailed plan outlining how they intend to achieve this goal. The journey is subject to the complex machinations of geopolitics, the economics of new energy, the legacy of previous investment and the appetites of consumers to pay for cleaner energy. Gas is one of the key transition fuels that bridge the shift from burning fossil fuel to generating clean energies.

The nature of the energy transition is a long journey towards an ultimately renewable destination. Change and surprise along the way are inevitable. That is what makes it complicated, but also rich with opportunity for astute and experienced investors.

#### Q: How have gas LDCs performed versus their electric peers?

**A:** Gas utilities (based on MSCI classification) outperformed electric utilities over the last 10 years by ~21%. In fact, between 2010 and 2015, gas utilities substantially outperformed their electric counterparts by closer to 60%, a major difference from the perspective of asset allocators. This relative outperformance was fuelled by strong growth in the rate base, a steep fall in the cost of gas largely from booming shale supply, increased margins that supported capex, perceived



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positive ESG attributes regarding switching from oil to gas for residential heating, improved safety credentials, and reduced gas leakages.

However, from early 2019, this performance trend began to reverse, a movement that has continued into 2020. What changed to precipitate this reversal in fortune was investors increasingly questioning the role of gas in a world more and more focused on decarbonisation. That question remains open.

### **Q: Fact check, how significant a contribution does gas usage make to emissions?**

**A:** While gas generates CO<sub>2</sub> emissions, it is far superior to other fossil fuels such as oil and coal, and compares favourably to some bioenergy fuels. According to the IEA<sup>i</sup> (International Energy Agency), natural gas shows some 40% of CO<sub>2</sub> emissions savings compared to coal, and around 20% for oil. In terms of overall emissions share, gas combustion accounts for around 21% of global energy sector CO<sub>2</sub> emissions, significantly below coal (44%) and oil (35%). The IEA notes that while gas is better on an emissions share basis, the gas share of gross emissions is rising partly on the back of its role in displacing coal in the energy complex. Gas is expected to range in share between 27% and 40% of the total energy complex by 2040. The pattern of gas usage and emissions changes by region, with the US a significant user of gas following the development of huge domestic shale reserves. Europe has been transitioning from coal in favour of gas. In Asia, India and China as a bloc account for some 60% of global coal demand, and gas plays a small but growing role as the core demand for energy still relies on coal, but its potential to displace coal on the path to renewables is massive.

### **Q: What are some of the key risks faced by LDCs?**

**A:** The key risk facing LDCs in relation to the energy transition is stranded asset risk, with the potential, over the long term, for customers to progressively 'electrify' thereby rendering some LDC pipeline assets obsolete. As the electric systems are increasingly decarbonised with renewable energy, this progressive electrification of energy use is seen by some as a necessary step to decarbonise our economies and meet net zero commitments.

Governments and regulators at various levels will also play a critical role in determining the speed of this potential transition and the future role of LDCs. For example, some governments are taking active roles in encouraging households to 'electrify' their energy needs. Indeed, Berkeley in California became the first city in the US to implement a ban on new residential gas connections in 2019<sup>ii</sup>. In the UK, the government has announced a ban on new residential gas heating from 2025 (excluding gas stoves).<sup>iii</sup> The Netherlands has taken the most aggressive approach, directly subsidising existing households to retrofit with electric appliances and is aiming to be 'gas free' by 2050, with plans to completely shut down the existing gas network.<sup>iv</sup> By contrast, a number of gas 'friendly' states in the US, including Oklahoma, Arizona, Tennessee and Louisiana, have passed state laws to stop local governments within their respective states from banning connections to the gas networks.<sup>v</sup> Given such opposing developments, investors are likely to continue to question the long-term economics of gas LDCs and, in particular, whether there is acceptable stranded asset risk in this sector.

### **Q: What role is the gas network currently playing in reducing greenhouse gas emissions?**

**A:** Over the near to medium term, gas LDCs are focussing on upgrading their existing infrastructure to reduce harmful leaks of methane. Methane is considered around 28 times more harmful than CO<sub>2</sub> for the environment. In doing so, gas LDCs are making a meaningful positive contribution to reducing harmful emissions.

Additionally, many LDCs are actively exploring changing the mix of gases they transport. This would include the addition of non-fossil fuel renewables, similar to the addition of ethanol to petrol with motor vehicles. In the case of gas, there are some renewable gases like green hydrogen (hydrogen made using renewable electricity to split water into hydrogen and oxygen by electrolysis) and renewable natural gas (RNG, sometimes called biomethane or biogas), which can supplant some of the existing methane volume, increasing the renewable rating of gas.

Through this path, 'enriching' the gas transported through LDCs via hydrogen and/or RNG could extend the life of gas LDCs and make a more meaningful contribution to emission reduction ambitions over time. Utilities are suggesting hydrogen could be blended (from between 5% and 10% of hydrogen) into the natural gas stream in the short to medium term.

RNG is derived from organic waste material found in food waste, animal and plant-based material. The Sempra-owned (NYSE: SRE) SoCalGas LDC, for example, is aiming to use 5% RNG by 2022 and 20% by 2030 in its gas network.<sup>vi</sup> Water utilities are also undertaking investment in RNG, for example, UK-based Severn Trent (LON: SVT) has been investing in biomethane plants that convert gas produced in the digestion of sewerage and food waste into gas that is injected back into the gas grids<sup>vii</sup>. Likewise, Duke Energy (NYSE: DUK) announced its intention to become a leader in RNG to meet a meaningful fraction of overall gas demand in North Carolina<sup>viii</sup>.

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Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and Global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly-owned subsidiary of New York Life Insurance Company. As at 30 November 2020, Ausbil manage over \$13.1 billion in funds under management.

**Q: Longer term, what role can gas networks play in the energy transition and in renewables, and what are the potential substitutions for methane within an LDC network?**

**A:** Over the longer-term (20 years and more) the future of gas LDCs and their role in the energy transition is less certain, posing challenges for investors. The 'bookends' in terms of long-term scenarios are as follows. At one end of potential scenario spectrum, gas LDCs will play a critical and sustainable role over the long term by transporting 100% renewable gases or hydrogen. At the other end of the spectrum, over the longer term, gas LDCs may become stranded as energy use is entirely electrified. At this point in time, confidence in any particular outcome is low, posing challenges, but also potentially attractive opportunities for investors.

There is the potential for existing gas networks to be converted to pure hydrogen or RNG pipeline infrastructure. However, as a pure energy form, this is expected to be very costly as it involves not just repurposing the existing infrastructure, but also replacing existing residential appliances. As such, the economics of a pure hydrogen or RNG network would likely require policy and fiscal support. Nonetheless, this path would allow LDCs to move from transition energy carriers to carriers of renewable energy, and thereby secure a future in the new world energy complex.

In gas networks, such repurposing is not a new idea. Before natural gas, town gas typically used coal or oil as the feedstock to produce an impure gas comprised of carbon monoxide, methane, carbon dioxide and other constituents. Town gas was mostly phased out and replaced by natural gas in the 1970s, requiring extensive repurposing of the gas infrastructure and household appliances.

**Q: What is the role of regulators in this changing environment?**

**A:** For investors, how regulators approach this issue will be paramount. We are starting to see some evidence that regulators are considering the implications of the energy transition for gas LDCs and, in particular, stranded asset risk. There is the potential for regulators to explicitly recognise stranded asset risk in formulating their decisions for allowed revenues for gas LDCs by, for example, reducing assumed asset lives and/or increasing allowed returns. This has, in turn, the potential to reduce stranded asset risk but also has its complexities around affordability and fairness. As investors, we need to continually monitor developments in this regard. Progressive and pro-active regulation is a critical part of the assessment of stranded asset risk being underwritten by investors in gas LDCs, and is 'par for the course' for professional infrastructure investors like Ausbil.

**Q: Considering all of the above, how should investors approach gas LDCs and are their attractive investment opportunities?**

**A:** The main conundrum for investors is how to price the risk and also the opportunity in LDCs. With respect to listed infrastructure, equity markets are often inefficient and short term in responding to, and pricing in, long-term structural risks and opportunities in the asset class. There is huge opportunity in this latency for nimble and informed investors who can truly value infrastructure assets intrinsically, and over their full lifecycle.

In terms of modelling, LDCs are priced for carrying gas with a terminal value assumed, and income generated typically across rolling five-year terms as approved by regulatory bodies. These tariff determinations add complexity and term structures to pricing LDCs that are complex, but decipherable for experienced infrastructure investors. There is often mispricing opportunity, as there is now, simply in valuations based on current gas uses and terminal values. Even without a future in hydrocarbon, the transition energy demand can make LDCs very profitable for investors entering at the right price.

So what about their future? How do you plan and price the opportunity in hydrogen and other biogas solutions but also account for potential stranded asset risk? The simple answer is that hydrogen is not a commercial energy yet, and is some way off. The unknowns make the option value of future hydrogen conversion almost negligible. This means that serious and prudent investors cannot currently ascribe accurate value to hydrogen and must invest purely on the value of LDCs as gas distribution assets. Similarly, investors also need to be alive to potential long-term stranded asset risk and its investment implications. A conservative approach to modelling and valuing LDCs is therefore considered appropriate. This is how Ausbil invests.

There is significant potential future value within this asset class that would accelerate on any future hydrogen announcements. Therefore, there is value in being invested in the asset class for this optionality. Hydrogen, undoubtedly, offers strong potential as an industrial energy source and as part of the total energy complex, and its base load would diversify intermittency in other sources. One final complication lies in the future capex required to convert and reinforce LDC networks for conversion to hydrogen. In a hydrogen world, some LDCs will likely not convert, whilst the best are expected to convert to new energy. There is latent, unrealised value in these current distribution networks that is currently valued at close to zero. In a changed world, LDCs could unlock this latent value and experience significant rerating in the both the energy and infrastructure complex.

## Q: Final thoughts on an approach to investing in gas LDCs?

**A:** Not all gas LDCs are created equal as it relates to the energy transition. As a result, we see the potential for greater bifurcation in performance over time as different countries, regions, companies and regulators approach the risks and opportunities presented by the energy transition differently. While there are some broad industry trends that will impact all gas LDCs, the specific circumstances will likely matter more over time. Our investments in gas LDCs will be considered and measured. We will remain focussed on those companies that are pursuing the energy transition more proactively, operating in regions with forward thinking regulators and where we understand the stranded asset risk potential. Others will simply be excluded from our portfolios.

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