

Investment Hazard: Ares Management launches energy fund despite past problems

Ares Management is launching an energy infrastructure fund, Ares EIF Management V, soon after broadening its energy-related assets.¹ Ares completed the acquisition of the specialty private equity firm Energy Investors Funds, with \$4 billion in assets under management, on January 1, 2015.²

Ares is joining a surge in private equity into energy-related funds. In 2014, energy-focused PE funds raised \$49 billion, according to Preqin, with 71% closing at or above target. So far, 2015 is off to a frenzied start with 70 energy-focused funds in market seeking \$43 billion (the previous 5 years saw an average of 46 energy related funds annually)³.

Ares may face headwinds in such a competitive market.

Through its acquisition of EIF, Ares inherited a history of underperformance. Three of EIF's four funds have lagged relative to peers, and the most recent fund missed the benchmark by 21 percentage points.

EIF investments encountered problems as well. Notably, a tragic accident at a Connecticut power plant resulted in the deaths of six workers with dozens more injured. In another investment, community resistance to a proposed New Jersey pipeline has slowed down plans.

Ares itself had invested in the energy sector prior to the acquisition of EIF, through its private equity group and through debt financing. One example is the Plasco Energy Group, an Ares portfolio company that recently declared bankruptcy after years of problems.

This spotty history raises questions regarding performance and Ares' due diligence process. As Ares seeks commitments for its new energy infrastructure fund, investors may want to examine:

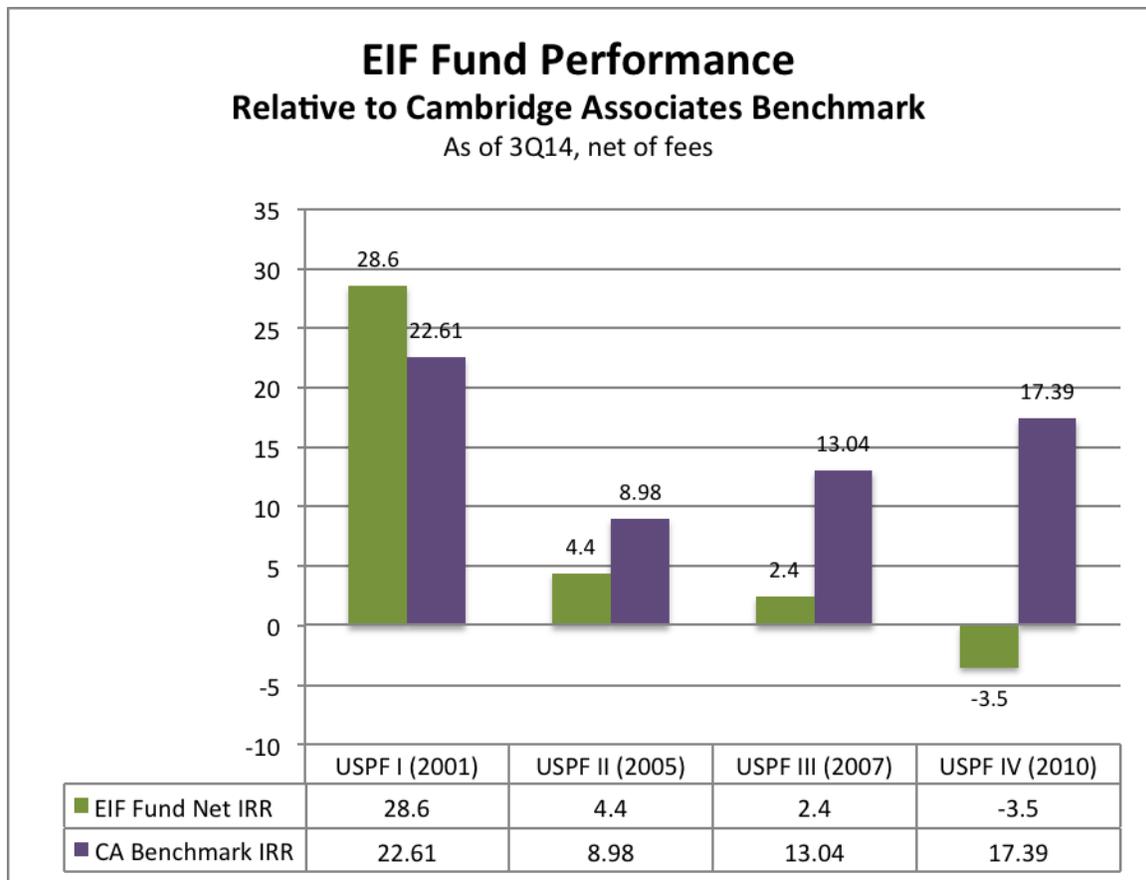
- What gives Ares confidence that it can deliver alpha for investors, given past underperformance?
- With so many energy funds on the market, why choose one with EIF's record of underperformance relative to peers?
- How does Ares conduct due diligence? How does it ferret out potential risks in the pre-acquisition phase?
- What clawback provisions will Ares offer investors in the event the fund underperforms?
- Does Ares's appetite for risk in energy investments match that of investors?

EIF's Track Record

A History of Underperformance

EIF has built portfolios of energy infrastructure assets. It has focused on those involved in power transmission, generation and midstream sectors. Its assets include conventional energy sources like oil, gas and coal as well as solar, hydro and landfill gas.⁴ Since 2001, EIF has launched four US Power Funds. While the first fund posted returns exceeding the benchmark, the three successor funds have posted returns substantially below the benchmark⁵. The most recent fund, USPF IV, launched in 2010, has a reported net IRR of -3.5 as of the third quarter of 2014, far below the Cambridge Associates benchmark of 17.39.⁶

By another measure, according to data from Preqin Ltd. energy-focused private equity funds that launched between 2002 and 2011 had average net returns of nearly 14 percent annually.⁷ For that same period, EIF's three funds averaged a 1.1 percent net return.



Source: CC CERA QUARTERLY REVIEW & PERFORMANCE MEASUREMENT REPORT 3Q14
 CAMBRIDGE ASSOCIATES U.S. Private Equity Index 3Q14

Kleen Energy Plant's Fatal Accident

On February 7, 2010, an explosion at an EIF-owned power plant under construction leveled sections of the facility, killed 6 workers and injured 50 others.⁸ The shock waves were felt in communities 40 miles away.⁹

“The explosion blew the siding off the structure, crumpled construction trailers, and sparked a conflagration that sent a dense plume of black smoke hundreds of feet in the air,” *Fortune* reported.¹⁰

EIF had started construction at the Kleen Energy plant in Middletown, Connecticut in 2008 and owned 80% of the project.¹¹ At the time of the 2010 explosion, the plant was in the final stages of construction and was scheduled to open in a few months. The plant eventually opened in 2011, 17 months after the explosion.¹²

At least 29 lawsuits were filed against Kleen Energy and the plant's general contractor, O&G Industries, according to the *Hartford Courant*.¹³ Five widows of the workers killed entered settlement agreements after mediation with a Superior Court judge. One widow, Dyann Chepulis, agreed to \$1.7 million settlement, but died four days after a probate court judge approved the final estate, the *Courant* reported, meaning she received no payment.¹⁴

The family of another victim, Ronald Crabb, who was 42 when he was killed, agreed to a \$2.55 million settlement, of which about half went to his two children.¹⁵

Kleen Energy's construction contractor, O&G Industries was cited by the Occupations Safety and Health Administration for 142 separate violations in the incident, including 117 “willful” violations, meaning “committed with plain indifference to or intentional disregard for employee safety and health.”¹⁶ O&G and its contractors were issued \$16.6 million in penalties by OSHA, for a total of 370 violations.¹⁷

Department of Labor Secretary Hilda Solis said, “the fines and penalties reflect the gravity and severity of the deadly conditions created by the companies managing the work at the site. No operation and no deadline is worth cutting common sense safety procedures. Workers should not sacrifice their lives for their livelihoods.”¹⁸

The governor of Connecticut issued an order banning the use of flammable gasses to conduct “gas blow” pipe

The fines and penalties reflect the gravity and severity of the deadly conditions created by the companies managing the work at the site.

No operation and no deadline is worth cutting common sense safety procedures. Workers should not sacrifice their lives for their livelihoods.

— Hilda Solis, US Secretary of Labor
OSHA news release regarding Kleen Energy

cleaning in September 2010, following reports from two state commissions appointed to investigate the Kleen Energy disaster.¹⁹

Since it opened in 2011, the Kleen Energy plant has had other problems. The facility experienced several disruptions in the first half of 2014, prompting a “Negative Watch” rating from Fitch, which said it “remains concerned that the uncertain volatility of Kleen’s cost structure and persistent operational failures could reduce financial performance over the long-term.”²⁰

For 6 weeks of winter weather in 2014, the entire Kleen Energy facility shut down to repair the steam turbine, which was experiencing unusual vibrations, according to Fitch. Another outage in the steam turbine disrupted revenue, which dropped by \$25 million, and cost \$3 million in repairs.²¹

The disruptions meant operating cash flow was insufficient to meet two scheduled debt service payments, Fitch said.²²

In mid-February 2014, Kleen Energy plant experienced a two-alarm fire that broke out in a combustion turbine. Firefighters said they contained an oil fire discovered on the floor of the turbine house that spread to the turbine housing and insulation, NBC Connecticut reported.²³ According to Fitch, the shutdown due to the fire cost \$6 million in revenue. The combustion turbine didn’t return to full capacity until June, 7, 2014.²⁴

Questions for Investors

- Was EIF’s due diligence into the Kleen Energy project and its contractors adequate?
- How have litigation, regulatory penalties & project delays impacted returns on EIF’s investment in Kleen Energy?
- How have Kleen Energy’s troubles impacted investors?

Pilgrim Pipeline Churns Controversy

EIF is providing financial backing to the Pilgrim Pipeline, a proposed project to build a bi-directional 180-mile pipeline from Albany, NY to Linden, NJ to transport crude oil southbound and refined petroleum products such as gasoline, diesel, heating oil and aviation fuel northbound. Pilgrim Pipeline listed the project’s price tag at \$820 million.²⁵

Pilgrim Pipeline has encountered political and community resistance to the proposed plan, including a campaign spearheaded by the New Jersey chapter of the Sierra Club. The Coalition to Stop Pilgrim Pipeline (CAPP) also includes groups like 350NYC, Food and Water Watch, Already Devalued & Devastated Homeowners of Parsippany, and the North Jersey Public Policy Network.

On its website, www.stoppilgrimpipeline.com, the Coalition states that its objections to the pipeline include “major impact on environment, public health and property values” and “damaging effects on urban communities and open spaces through which it passes.”²⁶

Pilgrim Pipeline said it intended to file its application with the State of New Jersey in the third quarter of 2014.²⁷ As of the first quarter of 2015, it had not filed.²⁸

However, Pilgrim has already hit at least one regulatory hurdle; the state utility denied its request to use a right-of-way in an approximately 35-mile segment of the proposed route. Public Service Electric & Gas Co. denied Pilgrim’s request in September 2014, and released a public statement in February 2015 confirming the fact.²⁹

The *Newark Star-Ledger* reported that a PSE&G spokeswoman said, “This right-of-way already contains transmission, distribution and gas facilities. At the time, we said that building another pipeline in the same right-of-way could interfere with these existing facilities, as well as future potential uses of this property for the provision of safe and reliable electric and gas service.”³⁰

In December 2014, the New Jersey State Assembly passed a bipartisan resolution opposing the Pilgrim Pipeline. It was sponsored by representatives of both parties, and passed in a 54-5 vote, with 13 abstentions.

One of the sponsors, Assemblywoman Linda Stender said the bipartisan support “speaks volumes about the concern for our drinking water, and the desire to keep it from being ruined by the oil that this thing would carry,” in a *Newark Star-Ledger* news story.³¹

Municipalities along the proposed pipeline route have also been resistant. The *Newark Star-Ledger* reported that 27 of 28 municipalities, plus two counties, along the proposed pipeline route have passed resolutions opposing it. The resolutions are non-binding.

The most recent town to join was Morris, where in March the all-Republican Board of Freeholders unanimously passed the resolution. The language states the board has concerns about hazards to the water supply, since the pipeline would pass through three aquifers and areas protecting public wells. The resolution calls for a moratorium on “any and all planning, proposals, surveying or construction” of the pipeline. It also notes that the pipeline would use Bakken shale oil, extracted through fracking in North Dakota, which “contributes to the climate change crisis by releasing large quantities of methane gas.”³²

Questions for Investors

- Was EIF's due diligence into the Pilgrim Pipeline proposal adequate?
- What expectations did Pilgrim have regarding community response to its proposal?
- The project appears to be behind schedule, how would delays impact EIF's investment?
- If Pilgrim is unsuccessful in securing the necessary approvals, what protections are in place for EIF & its investors?

Ares' Track Record

Plasco Energy Group

Ares became one of the biggest owners in Plasco Energy Group in 2010, providing \$110 million in equity financing through Ares Corporate Opportunities Fund III (ACOF III). The Canadian firm was founded in 2005 and seeks to convert municipal garbage into energy using a proprietary technology of injecting plasma to convert trash to electricity.³³

Plasco has been developing the technology for a decade, and had been working to secure commercial projects in Canada, California, the United Kingdom, Poland, the Caribbean and China.³⁴

In 2006, Plasco started construction on its pilot facility in Ottawa. The contract with the city included Plasco providing waste treatment, but Ottawa was also entitled to royalties as Plasco expanded its operations to other cities.³⁵ As the project developed, Ottawa ultimately entered into a 20-year contract with Plasco in 2011 for \$9.1 million annually to process 300 Tonnes (331 tons) of garbage, about one third of the city's trash.³⁶

However, after nearly 10 years of complications and delays, in February 2015, Plasco's deal with Ottawa fell apart. After missing deadlines to secure additional financing, Plasco declared bankruptcy.³⁷

"On the same day that city officials recommended that Ottawa end its relationship with Plasco Energy Group, the home-grown waste-management firm filed for creditor protection, resulting in the loss of 80 jobs and the end of an era for a company once considered a shining light in the local clean-tech industry," the *Ottawa Citizen* reported.³⁸

In court documents filed for the bankruptcy proceeding, Plasco's trash conversion technology was described as not being ready for commercial operating performance by KPMG, a firm brought in by Plasco for restructuring.³⁹

In an affidavit, KPMG partner Randall Benson said, “Plasco Group engineers concluded that certain aspects of the conversion system needed to be redesigned in order to sustain commercial operating performance on an economically viable basis.”⁴⁰

Questions for Investors

- In conducting due diligence on Plasco, what did Ares know about the firm’s history of delays before its 2010 acquisition?
- What assessment did Ares have of Plasco’s risk profile?
- How will Plasco’s bankruptcy affect Ares investors?

Endnotes

- 1 Ares EIF Management V, L.P. registered with the Delaware Department of Corporations January 28, 2015; Ares Management Q4 2014 Results - Earnings Call Transcript
- 2 Press Release “Ares Management, L.P. Closes Acquisition of Energy Investors Funds” January 9, 2015 <http://www.ares-ir.com/file.aspx?IID=4438507&FID=26960224>
- 3 Preqin Energy-Focused Fundraising, March 2015
- 4 www.eif.com accessed April 2015
- 5 CC CERA Quarterly Review and Performance Measurement Report 3Q14, Cambridge Associates U.S. Private Equity Index 3Q14
- 6 CC CERA Quarterly Review and Performance Measurement Report 3Q14, Cambridge Associates U.S. Private Equity Index 3Q14
- 7 CNBC, Private equity bets on energy ‘revolution’ – in oil and gas, November 17, 2014 <http://www.cnbc.com/id/102173514>
- 8 Fortune, “Kleen Energy’s fatal deal,” September 10, 2010 http://archive.fortune.com/2010/09/09/news/companies/kleen_energy_explosion_full.fortune/index.htm
- 9 Investment News, “Ill-fated Cn. Power plant owned by PE fund,” February 8, 2010 <http://www.investmentnews.com/article/20100208/FREE/100209868/ill-fated-conn-power-plant-owned-by-pe-fund>
- 10 Fortune, “Kleen Energy’s fatal deal,” September 10, 2010 http://archive.fortune.com/2010/09/09/news/companies/kleen_energy_explosion_full.fortune/index.htm
- 11 Investment News, “Ill-fated Cn. Power plant owned by PE fund,” February 8, 2010 <http://www.investmentnews.com/article/20100208/FREE/100209868/ill-fated-conn-power-plant-owned-by-pe-fund>
- 12 Middletown Press, “Deadly Kleen Energy blast caused changes in workplace safety,” February 7, 2013 <http://www.middletownpress.com/general-news/20130207/deadly-kleen-energy-blast-caused-changes-in-workplace-safety>
- 13 Hartford Courant, “Some Kleen Energy Explosion Settlements Revealed,” December 12, 2012 http://articles.courant.com/2012-12-12/news/hc-kleenenergy-settlement1212-20121212_1_kenneth-haskell-kleen-energy-peter-chepulis
- 14 Hartford Courant, “Some Kleen Energy Explosion Settlements Revealed,” December 12, 2012 http://articles.courant.com/2012-12-12/news/hc-kleenenergy-settlement1212-20121212_1_kenneth-haskell-kleen-energy-peter-chepulis
- 15 Hartford Courant, “Some Kleen Energy Explosion Settlements Revealed,” December 12, 2012 http://articles.courant.com/2012-12-12/news/hc-kleenenergy-settlement1212-20121212_1_kenneth-haskell-kleen-energy-peter-chepulis
- 16 https://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=NEWS_RELEASES&p_id=18117 OSHA News Release: 10-1081-BOS Aug. 5, 2010

- 17 https://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=NEWS_RELEASES&p_id=18117 OSHA News Release: 10-1081-BOS Aug. 5, 2010
- 18 https://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=NEWS_RELEASES&p_id=18117 OSHA News Release: 10-1081-BOS Aug. 5, 2010
- 19 Middletown Press, "Governor bans use of 'gas blows,' like the one that caused the Kleen Energy explosion in Middletown," Sept 22, 2010
- 20 "Fitch Places Kleen Energy Systems on Rating Watch Negative" June 27, 2014 <http://www.businesswire.com/news/home/20140627005804/en/Fitch-Places-Kleen-Energy-Systems-Rating-Watch#.VTFc4Fw-efQ>
- 21 "Fitch Places Kleen Energy Systems on Rating Watch Negative" June 27, 2014
- 22 "Fitch Places Kleen Energy Systems on Rating Watch Negative" June 27, 2014
- 23 <http://www.nbcconnecticut.com/news/local/Fire-at-Kleen-Energy-Plant-in-Middletown-245173751.html> February 12, 2014
- 24 "Fitch Places Kleen Energy Systems on Rating Watch Negative" June 27, 2014
- 25 Pilgrim Pipeline Holdings, LLC, "Northeast Regional Pipeline Project," presentation to Union County officials, June 18, 2014
- 26 <http://stoppilgrimpipeline.com>
- 27 Pilgrim Pipeline Holdings, LLC, "Northeast Regional Pipeline Project," presentation to Union County officials, June 18, 2014
- 28 All-GOP Morris freeholder board votes unanimously to oppose Pilgrim Pipeline March 26, 2015 <http://www.nj.com/morris/index.ssf/2015/03/all-gop-morris-freeholder-board-votes-to-oppose-pi.html>
- 29 Newark Star Ledger, "PSE&G: Pilgrim Pipeline can't use our right-of-way between Montville and Woodbridge," February 27, 2015 <http://www.nj.com/morris/index.ssf/2015/02/pseg-pilgrim-pipeline-cant-use-right-of-way-between.html>
- 30 Newark Star-Ledger, "PSE&G: Pilgrim Pipeline can't use our right-of-way between Montville and Woodbridge," February 27, 2015 <http://www.nj.com/morris/index.ssf/2015/02/pseg-pilgrim-pipeline-cant-use-right-of-way-between.html>
- 31 Newark Star-Ledger, "Assembly opposes Pilgrim Pipeline that would cross through 7 N.J. counties," December 19, 2014 <http://www.nj.com/politics/index.ssf/2014/12/assembly-opposes-pilgrim-pipeline-that-would-cross-through-7-nj-counties.html>
- 32 Newark Star-Ledger, "All-GOP Morris freeholder board votes unanimously to oppose Pilgrim Pipeline" March 26, 2015 <http://www.nj.com/morris/index.ssf/2015/03/all-gop-morris-freeholder-board-votes-to-oppose-pi.html>
- 33 Ottawa Business Journal, "Plasco secures \$140M in fresh equity financing," March 22, 2011 [http://www.obj.ca/Technology/2011-03-22/article-2353846/UPDATE%3A-Plasco-secures-\\$140M-in-fresh-equity-financing/1](http://www.obj.ca/Technology/2011-03-22/article-2353846/UPDATE%3A-Plasco-secures-$140M-in-fresh-equity-financing/1)
- 34 Ottawa Business Journal, "Plasco secures \$140M in fresh equity financing," March 22, 2011 [http://www.obj.ca/Technology/2011-03-22/article-2353846/UPDATE%3A-Plasco-secures-\\$140M-in-fresh-equity-financing/1](http://www.obj.ca/Technology/2011-03-22/article-2353846/UPDATE%3A-Plasco-secures-$140M-in-fresh-equity-financing/1)
- 35 Ottawa Citizen, "Ottawa severs ties with Plasco as company files for creditor protection," February 20, 2015 <http://ottawacitizen.com/news/local-news/plasco-energy-group-files-for-creditor-protection>
- 36 Ottawa Citizen, "Ottawa severs ties with Plasco as company files for creditor protection," February 20, 2015 <http://ottawacitizen.com/news/local-news/plasco-energy-group-files-for-creditor-protection>
- 37 Ottawa Citizen, "Ottawa severs ties with Plasco as company files for creditor protection," February 20, 2015 <http://ottawacitizen.com/news/local-news/plasco-energy-group-files-for-creditor-protection>
- 38 Ottawa Citizen, "Ottawa severs ties with Plasco as company files for creditor protection," February 20, 2015 <http://ottawacitizen.com/news/local-news/plasco-energy-group-files-for-creditor-protection>
- 39 Ottawa Citizen, "Plasco's Ottawa plan wasn't yet 'economically viable': court documents," February 12, 2015 <http://ottawacitizen.com/news/local-news/plascos-ottawa-plan-wasnt-yet-economically-viable-court-documents>
- 40 Ottawa Citizen, "Plasco's Ottawa plan wasn't yet 'economically viable': court documents," February 12, 2015 <http://ottawacitizen.com/news/local-news/plascos-ottawa-plan-wasnt-yet-economically-viable-court-documents>