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Learning From Energy Future's Mistakes


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Law360, New York (June 1, 2016, 12:40 PM ET) -- The bankruptcy filing of Energy Future Holdings, made on April 29, 2014, is significant for three reasons. First, it's one of the largest in U.S. history, with more than $40 billion in debt in distress at the time of the filing.[1] Second, it highlights the impact of the shale revolution on the American electric power industry by clearly illustrating the close correlation between upstream natural gas production and pricing with wholesale power prices. Third, the long road to a restructuring solution, still not at hand, illustrates the challenges that unique capital markets structures have in solving issues in highly regulated businesses.

What Happened?

On Feb. 26, 2007, TXU Corp. (NYSE: TXU), a Dallas-based energy company, was acquired by Kohlberg Kravis Roberts & Co. and Texas Pacific Group, two of the nation's biggest private equity firms.[2] KKR was a pioneer in the buyout world starting in the late 1980s, and both firms are consistently viewed to be elite financial sponsors. The transaction was valued at $45 billion, and as the term leveraged buyout (LBO) implies, a substantial amount of debt was used to acquire TXU and to take it private.

Three new segments were created as a result of the transaction, under the corporate umbrella of EFH.[3] The power generation business, renamed Luminant Energy, includes power generation plants, wholesale energy services, and the development and construction businesses. The transmission and distribution (T&D) segment is called Oncor Electric Delivery. This business includes high-voltage power lines and all wires down through the lower voltage lines leading directly into commercial and residential buildings. The third, TXU Energy, contains the retail electric businesses.

The transaction was announced with a great deal of publicity and promises. Specifically, price cuts of 10 percent were committed, and price protection guarantees were made through September 2008. In addition, green initiatives were announced, including the reduction of coal-fired generation plants from 11 to three, side-by-side with commitments to explore renewable energy sources and alternative energy technologies.[4]

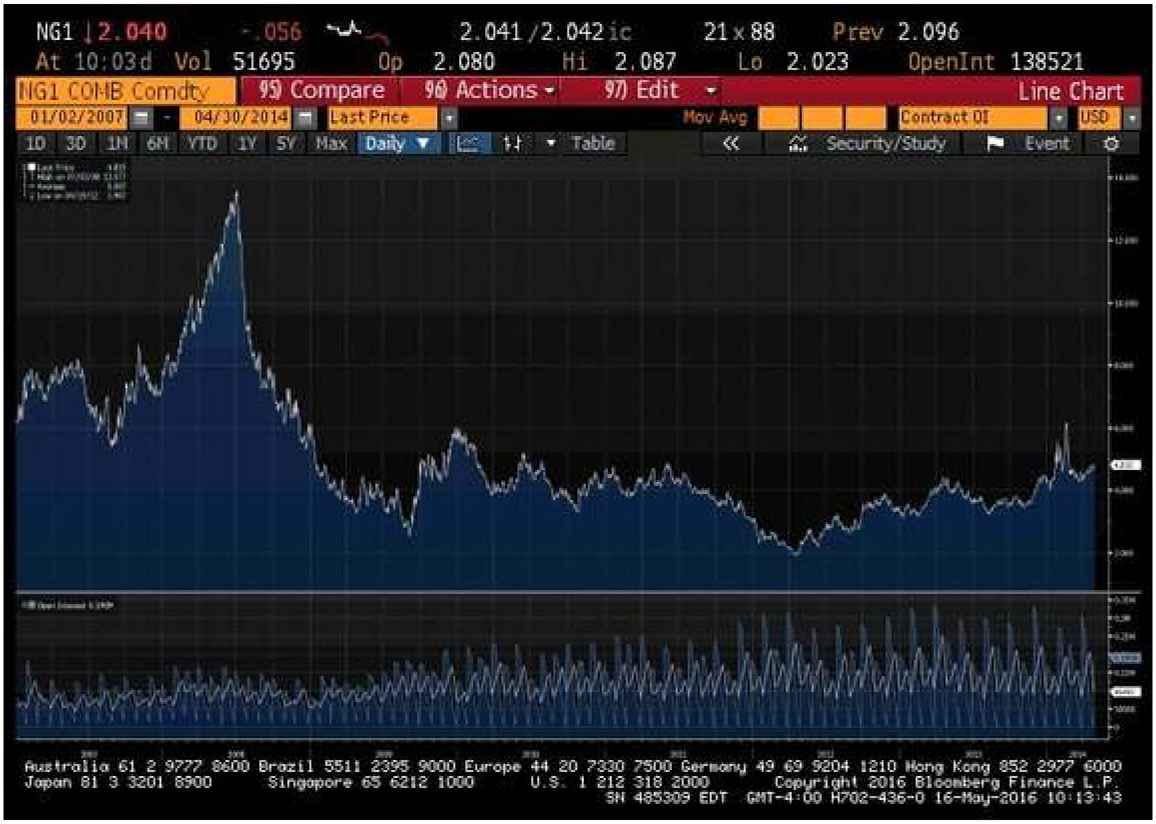
But seven years later, EFH filed the bankruptcy. At the time of the filing, and to this day, it is eighth on the top-10 bankruptcy list.[5]

		000's Assets
1 Lehman Brothers	2008	$691,100,000
2 Washington Mutual	2008	$327,900,000
3 WorldCom	2002	$103,900,000
4 General Motors	2009	$91,000,000
5 CIT Group	2009	$80,400,000
6 Enron	2001	$65,500,000
7 Conseco	2002	$61,400,000
8 Energy Future Holdings	2014	$40,900,000
9 MF Global	2009	$40,500,000
10 Chrysler	2014	$39,300,000

Yahoo!Finance

In order to understand why EFH filed, it is critical to realize how power prices in the U.S. are set. In almost all regions of the country, wholesale power prices are closely correlated to natural gas prices.[6] (One exception is the Midwest.) The reason for this is that gas-fired generation is most frequently the market-clearing mechanism. The marginal cost of a gas-fired power plant to produce megawatt-hours very often sets power prices.

There were steep declines in natural gas prices during the 2007-2014[7] period that caused the EFH companies to suffer severe margin pressure. The price of natural gas dropped from $11.32 per thousand cubic feet to $4.75 in the latter half of 2008, (see Bloomberg chart below) shortly after the TXU purchase closed.[8] By 2010, the price had fallen further down to about $4 per thousand cubic feet, and today it is just over $2. During this time, average wholesale prices for electricity in North Texas, as an example relevant to EFH, dropped to $29.36 per megawatt-hour late last year, from $70.40 in 2008.[9]



The Shale Revolution

What caused the commodity price declines? Since 2007, shale gas production in this country has grown from being about 10 percent of total U.S. gas production to almost 60 percent this year.[10] Shale gas specifically refers to natural gas production that originates in tight rock formations that require more advanced and expensive techniques, such as horizontal drilling and multistage hydraulic fracturing, to produce. This marked a big change, illustrated by the fact that the U.S. Department of Energy's Energy Information Administration (EIA) did not forecast shale gas delivering more than 50 percent of U.S. supply until 2035. The velocity of U.S. shale gas production caught a lot of experts by surprise, and was 20 years ahead of the EIA's own schedule. By the end of 2014, about 65 trillion cubic feet (Tcf) of shale gas in the U.S. was produced in total. This burst in production had a direct impact on wholesale power prices in this time frame. Gas-fired generation became much cheaper, and power prices declined as a result. It became harder and harder for EFH to service its substantial debt load.

Chapter 11 Filing Approved[11]

The Delaware Bankruptcy Court approved a Chapter 11 reorganization plan[12] on Dec. 3, 2015, just six months ago. The plan calls for unsecured creditors to have an opportunity to earn a substantial return on their claims by participating in an $18 billion acquisition of the Oncor subsidiary. The law firm White & Case LLP led much of the work, and based its strategy on these core ideas:

- Use the potential upside valuation of Oncor to settle claims with junior creditors;
- Pay cash to take out the creditors of the holding companies; and

- Satisfy $25 billion of secured lender claims by either granting them new debt equal to the fair value of their collateral, or by giving them ownership of the collateral itself.

Two elements in the plan are unique. First, Oncor is to be acquired by the unsecured creditors, who will either put up or arrange for $12.6 billion of new capital. $7.1 billion of equity necessary for the deal to go through would be "backstopped" or directly provided by Hunt Consolidated, a private investment fund based in Dallas. The remainder, $5.5 billion, will be structured as new holding company debt. Second, Oncor is to be converted into a real estate investment trust, or a "REIT." REITs are pass-through structures, which means that the cash flow or earnings generated by the vehicle "pass through" untaxed to the investors in the REIT. There is no double taxation.

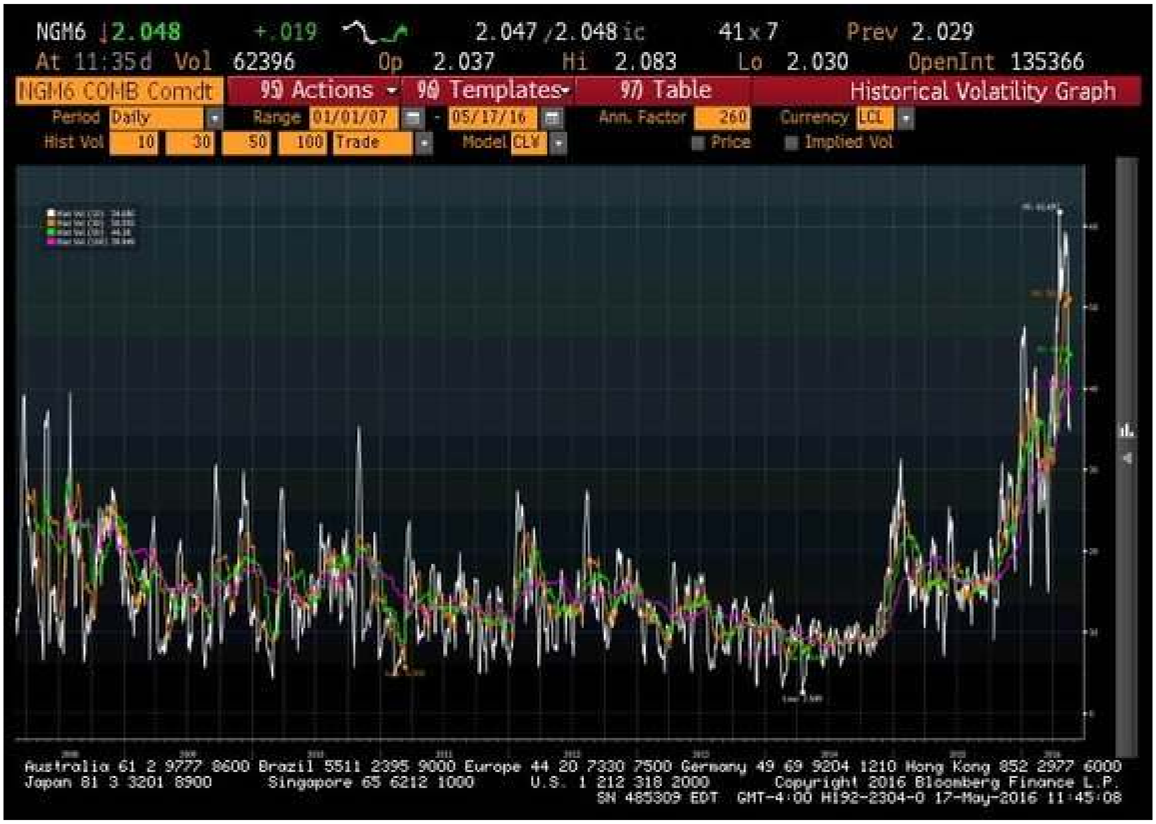
Regulatory Approval … Sort Of

On March 24 of this year, the Public Utilities Commission of Texas approved the transaction, but added that the potential annual tax savings of $250 million will have to be set aside. The savings are to be revisited at a later date for potential refund to ratepayers. This PUC decision means that one of the biggest deals ever to grow out of a bankruptcy case, the $17 billion buyout of Energy Future Holdings Corp.'s electricity transmission business (Oncor) had cleared a regulatory hurdle.[13] However, a month later, the Hunt group asked for a new ruling, arguing that the deal cannot go through as planned because of uncertainty over the $250 million in annual savings.[14]

Lessons Learned

The final chapters of the EFH bankruptcy have not yet been written, but there are lessons learned based on what has happened thus far. First, the interconnectedness of the energy complex was not considered carefully enough. The oil and gas business is usually viewed separately from the electric power business in this country. However, most industry professionals do not think of the energy business this way. That is why the term "energy complex" came to be — the vast industry running from resources in the ground all the way to electric sockets in homes and gasoline in car tanks is viewed as an integrated whole. Natural gas-fired generation plants drive clearing prices for wholesale electricity, and natural gas comes from the oil and gas side of the energy complex. The two are directly tied together, and it looks like this was not given the attention it deserved when the LBO was structured.

Second, commodities are very volatile. As the Bloomberg chart below illustrates, the most liquid natural gas contract in the U.S. had volatility ranging from 30 percent to 50 percent from 2007 to 2015.



The LBO structure does not lend itself to businesses that have cash flows dependent upon commodity prices, or at a minimum influenced by them. Equity capital can serve the purpose of taking losses when prices run low, and capturing upsides when prices run high. But a heavy debt load needs stable, predictable cash flows to be sustainable.

Third, there was a lack of understanding of the role that regulators play. Regulated businesses are different. Regulators serve the public interest and have a responsibility to ensure that ratepayers do not assume risks beyond their service requirements. Look at the PUC's mission statement. "We protect customers, foster competition, and promote high quality infrastructure."[15] Often, regulators have been known to capture excess returns from businesses and return them to the very ratepayers who funded the capital investments to begin with. It should not be surprising that the PUC of Texas paused on the $250 million in tax savings, despite all of the criticism it has received for doing so.

Lastly, and perhaps most important, drifting away from fundamental valuation principles is a mistake. Good blocking and tackling valuation work focuses on the underlying cash flow potential of any company. The use of specific structures, such as the REIT structure, to enhance returns is perfectly fine and common. But valuation should be tested independent of capital structure and tax structure, in order to test the true viability of the business plan. If annual tax savings, like the $250 million in the Oncor deal, are make-or-break, it calls into question the fundamental valuation of the deal and the business model itself. Can it work without the tax savings? If not, why not?

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