The Financial "Electric Chair"

The Largest Energy Supplier in Texas Faces Bankruptcy

By Alan Lammey

While the overall success of electricity deregulation in Texas is a topic up for debate among proponents and critics, the past and looming failures of major players in the electricity industry act as a reminder that the financial side of any business can be very unforgiving. Such is the case for the owner of electricity giant TXU Energy, which is facing imminent bankruptcy. Texas business owners could experience some fallout as a result of the company's failure, which sent shockwaves throughout the electricity industry in the Lone Star State.

In the 11 years since deregulation began, a number of retail electricity providers have come and gone, either via bankruptcy due to poor management-to-market conditions resulting from record-high-priced natural gas or the collapse of parts of the banking and lending industry in 2008-09.

The most recent sign of the callous nature of the energy industry is the looming bankruptcy of Texas Competitive Electric Holdings. The firm owns retail electricity provider TXU Energy, as well as wholesale electricity generator Luminant, which is the largest energy supplier in Texas. Now all are headed for the financial electric chair.

A LITTLE BACKGROUND ON DEREGULATION

In 2002, the Texas electricity industry became a "deregulated" market, meaning that the state opened up to offer electricity consumers a bevy of competitive choices as to whom they could purchase their power from. Since then, approximately 85 percent of Texas commercial and industrial consumers have switched away from their former incumbent providers to a competitive retail electricity provider (REP) at least once in the deregulated areas.

Texas consumes about $25 billion worth of electricity every year—the highest consumption of any U.S. state. In fact, the Lone Star State's annual electricity consumption, all by itself, is comparable to that of Great Britain and Spain. If the state were an independent nation, its electricity market would be the 11th largest in the world.

Because so much money and service reliability are at stake, Texas lawmakers created and designated the Electric Reliability Council of Texas (ERCOT) to serve as the oversight authority for grid reliability and operations, in order to ensure that no particular buyer or seller would gain an unfair advantage in the market.

BIG MONEY + BIG MARKET VOLATILITY = EVEN BIGGER BUSINESS RISK

While it's been rumored for a number of years that Texas Electric Holdings was in trouble and would eventually face financial disaster, some recent analysis by Moody's analysts has suggested that the company could actually run out of financial resources before the end of 2013. This would, in turn, potentially pull their parent company, Energy Future Holdings (EFH), into the bankruptcy black-hole vortex as well.

This is because EFH and its subsidiaries hold more than $40 billion in debt; Texas Competitive Electric Holdings owes $30 billion of that debt, yet is only valued at around $14 to $15 billion.

If the two companies move toward bankruptcy, in terms of total debt outstanding, it could mark one of the biggest corporate bankruptcies of all time. To put the situation in perspective, the Enron collapse in 2001—which captured daily newspaper headlines for nearly three years—was responsible for about $11 billion in losses.

SO HOW IN THE @#$& DID THIS HAPPEN?!

In a nutshell, this colossal failure for EFH stems from one of the biggest leveraged buyouts in history, which took place in 2007 and was worth around $45 billion. That deal was largely based on the price of natural gas, which at the time was trading between $7 and $9 per million British Thermal Units (MMBtu). In order for EFH to service the debt, natural gas prices could not fall lower than $6/MMBtu on an extended basis. In Texas, up to 70 percent of the capacity to generate electricity comes from natural gas–fired power generators. Therefore, whenever the price of natural gas goes up or down, electricity rates will generally follow.

In 2008, the gold rush to natural gas "shale plays" emerged, which sent the United States' natural gas market collapsing into a five-year bear market: prices in 2012 fell to near-record lows—under $2 per MMBtu. For the most part, the natural gas market has been trading in a $3 to $4 range for the past few years, which is about 50 percent of the price needed for Texas Competitive Electric to service their debt.

Multitudes of other electricity providers have entered into the Texas market (with notably less debt to service). Texas Competitive Electric wasn't able to offer electricity rates competitive with these companies—and therein lies the primary source of the downfall.

NO POWER DISRUPTION EXPECTED, BUT THERE WILL BE SOME FALLOUT

If EFH's subsidiaries were to stop operating, the Texas Public Utility Commission (Texas PUC) would intervene in order to keep the power flowing for a sizeable percentage of the state's population. However, the bankruptcy of EFH isn't expected to create any power-generation issues or disruptions for the Texas power grid. In fact, during the process, a majority of their generation plants will never stop producing electricity. That's not to say that it won't cause a multifaceted web of legal matters, as EFH also owns the utility Oncor (formerly TXU). Oncor owns and operates all of the power lines and meters in the Dallas area, as well as a large portion of North and Central Texas. But Oncor is owned by an unconnected subsidiary and is not anticipated to apply for bankruptcy protection.

If Luminant goes bankrupt or changes ownership, it could affect all Texas business owners in one area: electricity rates. This is because it's highly likely that trading costs and the size of bids that Luminant puts into the grid will increase. That means that REPs or other entities trading with Luminant will have to pay more for their electricity; in turn, those higher prices could eventually trickle down to a large percentage of Texas electricity customers. Because Luminant owns 20 percent of the generation assets in Texas, it would be impossible for everyone not to be affected by the trickle-down effect.

Depending on the sort of bankruptcy that occurs, Texas businesses that currently use TXU Energy as their energy provider may need to begin looking for another provider, but it's important for business owners to understand that the power will never stop flowing and the lights will never go out.

If a REP goes out of business, the consumer is simply switched over to the provider of last resort (POLR), which is typically Green Mountain for a majority of Texas. After the switch is made, electricity consumers will be placed on a month-to-month contract and can leave Green Mountain for another provider at any time without having to pay a penalty. If your REP declares bankruptcy in order to restructure (i.e., avoid paying their debts) yet still plans to stay in business, energy consumers will not notice any change, and they will continue to be provided with electricity. As far as we know now, this is what will more than likely happen with TXU Energy.

Interestingly, over the years since deregulation began, many electricity consumers chose to remain with the incumbent TXU Energy because they felt that the firm offered the most stability in a drastically changing market. This ironic choice just goes to show that in this day and age, no company, in any industry, is "too big to fail." **N**

Alan Lammey has 15 years' experience as an oil, natural gas, and power-markets analyst and journalist, and is best known for his forward-thinking energy-market analysis. He can be reached via www.TexasEnergyAnalyst.com or alammey@TexasEnergyAnalyst.com.