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EFH Has Few Good Options After Big Bet On Oncor Deal Sours

By **Matt Chiappardi**

Law360, Wilmington (April 29, 2016, 11:19 PM ET) -- Energy Future Holdings Corp. has few immediate options to regroup after its innovative $20 billion gamble to reorganize its electricity transmission unit Oncor into a real estate investment trust appears to be history, leaving the mega-Chapter 11 in a state of costly and uncomfortable uncertainty, experts say.

When EFH told the Delaware bankruptcy court Thursday that the deal at the heart of its hard-fought Chapter 11 plan was dead over conditions Texas regulators had put on approval of the transaction, it shifted a case that seemed to be on an orderly march to a bankruptcy exit into apparent disarray.

The complex and unusual sale of the equity in Oncor Electric Delivery Co. LLC as a REIT had never been tried before for an asset of its size in a heavily regulated industry, experts said, and the Public Utility Commission of Texas balked at the tax savings from the deal structure not being shared with ratepayers.

Some of the investor group backing the transaction, which was heralded as a novel way for a $42 billion case to manage a relatively quick bankruptcy exit, insisted EFH was jumping the gun and that the deal may yet have a shoot of green. But experts say that barring the shaky chance of the deal's resurrection, the power giant could find itself mired in an expensive bankruptcy purgatory for some time.

"If this transaction is really dead, the bankruptcy case could drag on for a year or more and accumulate gigantic amounts of professional fees," said Sam Stricklin, a partner with Gruber Elrod Johansen Hail Shank LLP.

Professional fees in the EFH case have already been recorded at $300 million, not counting the monthlong trial that resulted in its Chapter 11 plan's confirmation, and Stricklin says that the cost may ultimately wind up being passed onto consumers, contradicting what the PUC was trying to achieve in the first place.

"I applaud the commission's desire to share some of those tax savings, but they may be cutting off their nose to spite their face," he said.

On Thursday, EFH sent a memo to its employees assuring them that they "do not know with certainty" whether the deal will, in fact, be finalized, despite comments in court from the company's bankruptcy attorney Marc Kieselstein of Kirkland & Ellis LLP that it was "crystal clear" the investor group backing the deal would not be funding it.

The deadline for EFH to switch to an alternate game plan tolls at midnight April 30, and the power giant said it has “always planned for the possibility that the Oncor transaction may not close as planned due to considerable regulatory and funding conditions.”

The company said it plans to chart a different course, but wants to retain the key elements of a tax-free spinoff of affiliate Texas Competitive Electric Holdings Co. LLC and a sale of its 80 percent stake in Oncor.

But if the investor group, a consortium led by Hunt Consolidated Inc., won’t fund the deal, simply finding an alternative group of investors is not going to be an easy task, given the historic downturn in the energy commodity markets, said Bruce A. Markell, a bankruptcy law professor at Northwestern University’s Pritzker School of Law.

“Finding another group of investors is the obvious way out,” Markell said. “But the turmoil in the energy market has an effect. You can’t just substitute in a new buyer.”

And maintaining a deal structure that’s the first of its kind, at least of this scale, for the heavily regulated electricity transmission space also presents mammoth challenges.

Markell said bankruptcy practitioners must take risks as part of their profession and didn’t fault them for making the gamble.

“The only novelty limitation is how intelligent and creative an attorney is, and EFH, as I understand it, has some pretty intelligent and creative lawyers,” he said.

The novelty of the deal may have played a role in regulators’ reaction, which went against investors' interest in the transaction.

No one had any previous deal to compare it to and figure out what an appropriate rate of return on equity would be, said J. Paul Forrester, partner with Mayer Brown LLP.

“The Texas PUC is facing, for the first time, the question of how it will treat a REIT in an acquisition,” Forrester said. “The REIT is eminently sensible, efficient and permissible. The problem is, it’s new in the electric energy world.”

Where EFH can go from here is an open question. The power giant could revive earlier talks with suitors such as NextEra Energy Inc. for some sort of sale transaction, Forrester added.

“There are options, but they aren’t necessarily as attractive,” he said.

Thomas J. McNulty, director in the valuations and financial risk management practice at Navigant Consulting, said that EFH might be able to save the deal by negotiating with the regulators to perhaps “split the difference” between ratepayers and the investors in terms of tax savings.

But investors may not be open to the uncertainty on their returns and it would be “back to the drawing board” for EFH, he said.

McNulty questioned whether a REIT structure was indeed appropriate for the Oncor deal. While there may be real estate such as rights of way for transmission lines, Oncor is not really the type of asset REITs were designed for, such as shopping malls and large housing developments, he said.

“It can be done,” McNulty said. “It’s not unsound, but underlying everything is that pretax return. If it’s too high, some of it must be returned to the ratepayers and that’s not a similar concept to a pure free-market business.”

The Texas PUC has not been immune from criticism over the conditions it imposed on approval, with Lone Star State heavyweights such as Kay Bailey Hutchison, Ross Perot Jr. and Kelcy Warren weighing in publicly.

But McNulty said the PUC was just doing its job of representing the interest of ratepayers, and questioned whether EFH fully anticipated how the commission would react.

“You’re creating a lot of value and regulators who say, ‘We would like a taste,’” McNulty said. “What people often lose in the fog of war is that this is a regulated business, and a lot of big-time deal makers are accustomed to unregulated businesses.”

EFH is represented by Edward O. Sassower, Stephen E. Hessler, Brian E. Schartz, James H.M. Sprayregen, Marc Kieselstein, Chad J. Husnick, Steven N. Serajeddini and Andrew McGaan of Kirkland & Ellis LLP, and Mark D. Collins, Daniel J. DeFranceschi and Jason M. Madron of Richards Layton & Finger PA.

The case is In re: Energy Future Holdings Corp., case number 1:14-bk-10979, in the U.S. Bankruptcy Court for the District of Delaware.

--Editing by Mark Lebetkin and Philip Shea.
