

Vinson & Elkins

# Energy Series

Unpacking the  
Freeze in Texas:  
Lessons Learned  
and a Path Forward

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# THE EVENT

## OVERVIEW

- Record-breaking low temperatures throughout entire State of Texas due to a series of severe winter storms occurring on and about February 10-20, 2021
- Electricity demand in Texas reached records highs (~69,000 MW on February 14)
- Nearly 50% of Texas' power generation (~52,000 MW) was forced offline at one point through the storms and for a variety of reasons
- Emergency load shedding measures implemented by ERCOT for ~70.5 hours, with a maximum load shed request of 20,000 MW
- Electricity prices within ERCOT administratively set at the \$9,000/MWh systemwide offer cap for ~90 consecutive hours
- Spot market natural gas prices soared during the event to over \$400/MMBtu

# IMPACTS ACROSS THE ENERGY INDUSTRY

- Bankruptcies
- Litigation – contract claims, injury and wrongful death suits
- Legislative proposals
- Contractual workouts
- Debt issuances and alternative financings
- Proposals for investments in Texas power infrastructure
- Public disclosures of impacts

# THE PATH FORWARD

# Weatherization and Emergency Preparedness

## Proposed Legislation

- House Bill 11
  - Would require generators and transmission & distribution providers to prepare for extreme weather emergencies
- House Bill 13
  - Would establish the Texas Energy Disaster Reliability Council to prevent interruptions in electric service during a disaster
- Senate Bill 3 (Omnibus Bill)
  - Requires weatherization of all electric generation and transmission facilities, natural gas facilities, and pipelines
  - Imposes significant fines for non-compliance

## PUC Rulemakings

- Project No. 51841
  - PUC will review 16 Tex. Admin. Code § 25.53 relating to T&D emergency operations plans
- Project No. 51840
  - Created placeholder rulemaking project for establishment of weatherization standards for electric utilities and power generation companies



# Retail Pricing

## Proposed Legislation

- House Bill 16/Senate Bill 1279
  - Would prohibit retail electric providers from offering wholesale index priced plans to residential and small commercial customers
  - Passed House and Senate—Senate amendments currently under review in the House

## PUC Rulemaking

- Project No. 51830
  - PUC will review wholesale indexed products for compliance with customer protection rules for retail electric service

# Communication and Coordination

## Proposed Legislation

- House Bill 12
  - Would require the Texas Division of Emergency Management in coordination with the Governor's office, the PUC, and ERCOT, to develop a statewide disaster alert system that would alert Texans to widespread power outages
- Senate Bill 3 (Omnibus Bill)
  - Establishes emergency alert system to notify Texans when power demand exceeds supply
  - Requires the Texas Division of Emergency Management to categorize winter storms similarly to the manner in which hurricanes are categorized
  - Establishes the Texas Energy Reliability Council to enhance coordination and communication in the Texas energy and electric industries

## PUC Rulemakings

- Project No. 51888
  - Review of standards and processes regarding the designation of critical load customers
- Project No. 51889
  - Review of communications for the electric market
- Project No. 51839
  - Review of coordination between the electric and natural gas industries

# Wholesale Pricing

## Proposed Legislation

- Senate Bill 3 (Omnibus Bill)
  - Requires PUC to establish an emergency system-wide offer cap for the wholesale market based on actual costs of generation at the time of the emergency
  - Directs ERCOT to procure ancillary services sufficient to manage reliability impacts of intermittent generating resources and assign the costs to intermittent generators
- Senate Bill 1278/House Bill 4466
  - Would require intermittent generating resources to directly purchase additional ancillary services from dispatchable generators to “firm up” deliverability for the intermittent resources

## PUC Rulemaking

- Project No. 51871
  - Proposed Rule would modify the value of the low system-wide offer cap (LCAP) by eliminating the provision that ties the value of the LCAP to natural gas prices
  - Replaces this provision with one that ensures resource entities are able to recover their actual marginal costs in scarcity pricing situations
  - PUC approved Proposal for Publication in the Texas Register on May 7, 2021

## ERCOT

- Undergoing PUC-ordered forensic audit of market processes during the winter storm
- Report expected by the end of the current legislative session

# ERCOT Securitization

## Proposed Legislation

- **Senate Bill 1580**
  - Would allow electric cooperatives to use securitization financing to recover extraordinary costs from the storm
  - Bonds would be repaid through nonbypassable fees to all customers connected to the electric cooperative's system assets
- **House Bill 4492**
  - Would allow ERCOT to use securitization financing to fund outstanding market participant short-pays that would otherwise be uplifted to the entire wholesale market
  - Bonds may be issued with a term not to exceed 30 years; subject to issuance of a PUCT financing order
  - Financed amount would be paid by a nonbypassable fee, which would be allocated to market participants
- **ERCOT**
  - Will not begin invoicing wholesale market participants for winter storm-related short-pays until the conclusion of the legislative session

# IMPACTS ON HEDGED RENEWABLE PROJECTS

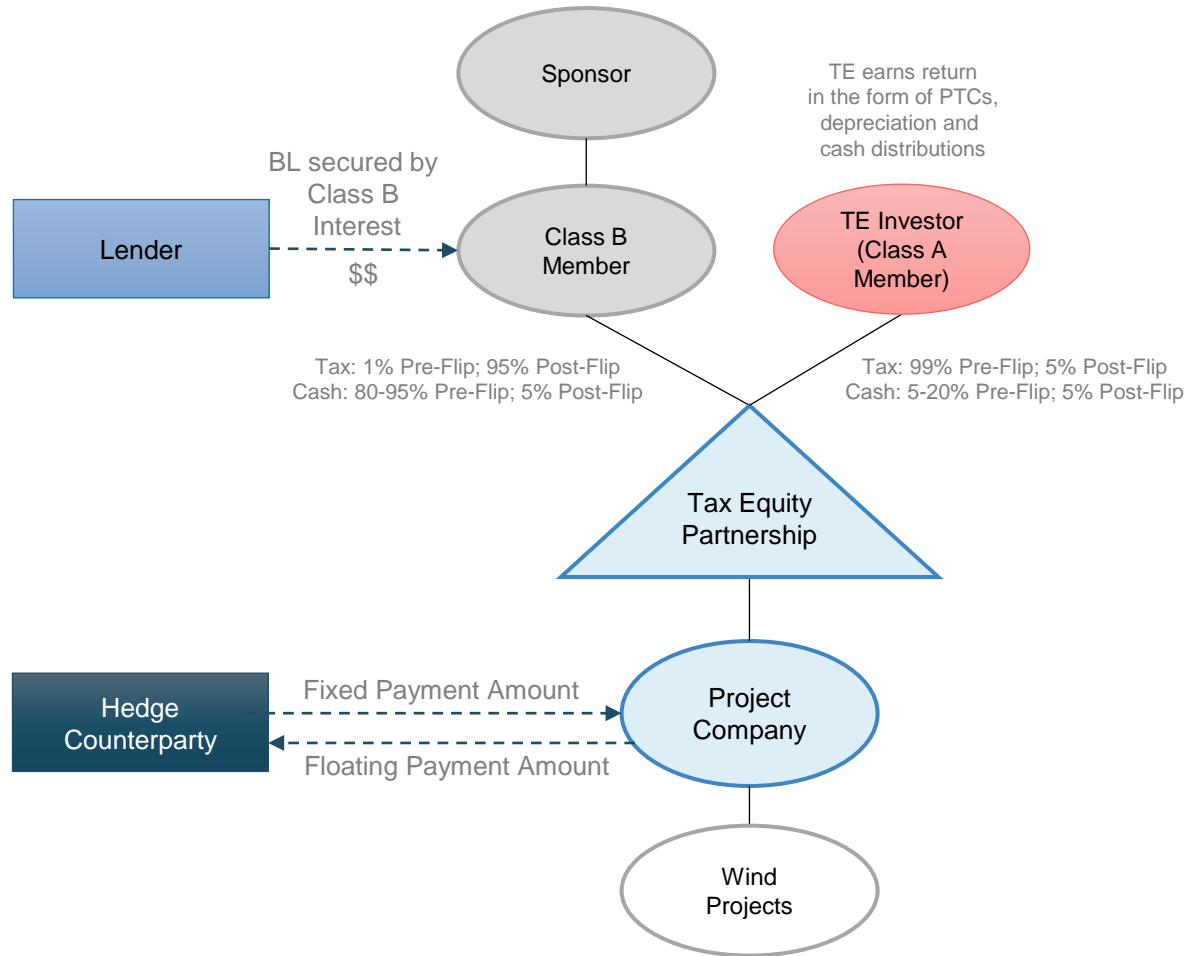
## HEDGE BASICS

- Most Hedged transactions are documented on the 2002 ISDA Master Agreement or Edison Electric Institute (EEI) form
- Fixed for Floating: Party A (Hedge Provider) pays fixed price for power and Party B (Project Company) pays floating (merchant market) price; with payments netted at settlement
- Hedges can be either financially or physically settled; for physical settled hedges, Party A actually purchases power as part of the transactions: ISDA form incorporates provisions relative to physical settlement through incorporation of Power Annex.
- Historically, the bulk of renewable energy hedges have been “fixed-volume” hedges where settlement is based on fixed volume of energy for each settlement period.
  - Such hedges have generally been sized as P90 or P99 production, which was thought to serve as a sufficient mitigant to the risk of underproduction.
- However, with production at or near zero for multiple days where replacement cost was \$9000 per MWh, as opposed to a fixed price @ \$20, many of the hedged Projects racked up losses in the tens of millions over the course of the event.

## THE PLAYERS

- **Project Sponsors**
  - Independent Power Producers (IPPs) often affiliated with regulated utilities
  - Financial Sponsors
- **Hedge Providers**
  - Commodities Desks at Investment Banks (Citi, JPM, J Aron, Merrill Lynch, Morgan Stanley)
  - Traditional Energy Companies (BP, Shell) sometimes back-to-back with Commodities Desk
  - Insurance Companies (Allianz, Munich RE) offer similar products, i.e. Revenue Put
- **Tax Equity Investors**
  - Banking entities, sometimes affiliated with Hedge Providers
  - Corporate Entities (GE, BHE)
- **Back-leverage/Cash Equity**
  - Commercial Banks and Insurance Companies
  - Private Equity and Pension Funds

# STANDARD PARTNERSHIP FLIP STRUCTURE



- Bulk of Tax Investor return derived from tax benefits (PTCs (wind), ITCs (solar) and Depreciation), though some cash is required for economic substance.
- Hedge Provider typically takes a lien on the Project assets, often subject to forbearance agreement for benefit of TE.
- Sponsors often monetize long term cash flows by raising back-leverage debt or selling cash equity interest at or above managing ember



## TAX AND OTHER CONSIDERATIONS

- Tax Equity
  - Partnership Capital Accounts
  - Deficient Restoration Obligations
  - Allocation of Hedge Losses
  - Cancellation of Indebtedness Income
- Sponsors
  - Typically, cannot utilize tax incentives and are dependent on relatively small club of Tax Equity providers to monetize PTCs and ITCs, which motivates behavior outside of economics of affected Projects
- Hedge Provider/Rescue Finance Party
  - Insofar as OpEx is high relative to merchant pricing curves, focused on ability to monetize remaining PTCs
  - Relationships with Sponsors (often Investment Bank clients) and Tax Equity Investors

## THE DEBATE OVER FORCE MAJEURE

- ISDA Provision (5.2(b)(ii)) applicable to financially settled instruments only provides for deferral of obligation while FM is outstanding.
- Power Annex applicable to physically settled transactions defines Force Majeure as: an event or circumstance which prevents the Claiming Party from performing its obligations under one or more Power Transactions, which event or circumstance was not anticipated as of the date the Power Transaction was agreed to, which is not within the reasonable control of, or the result of the negligence of, the Claiming Party, and which, by the exercise of due diligence, the Claiming Party is unable to overcome or avoid or cause to be avoided. Force Majeure shall not be based on (i) the loss of Buyer's markets; (ii) Buyer's inability economically to use or resell the Product purchased hereunder; (iii) the loss or failure of Seller's supply; or (iv) Seller's ability to sell the Product at a price greater than the Contract Price. Neither party may raise a claim of Force Majeure based in whole or in part on curtailment by the Transmission Provider unless (i) such party has contracted for firm transmission with a Transmission Provider for the Product to be delivered to or received at the Delivery Point and (ii) such curtailment is due to "force majeure" or "uncontrollable force" or a similar term as defined under the Transmission Provider's tariff; provided, however, that existence of the foregoing factors shall not be sufficient to conclusively or presumptively prove the existence of a Force Majeure absent a showing of other facts and circumstances which in the aggregate with such factors establish that a Force Majeure as defined in the first sentence hereof has occurred.
- Project vs Grid Level Event – is the Claiming Party prevented from producing energy at the Project or delivering energy (whether produced or purchases) at the settlement point.

# IMPACT ON THE NATURAL GAS INDUSTRY

## OVERVIEW

- **Weather impacts**
  - Natural gas power generation
  - Natural gas production, transportation, compression and processing
- **Economic impacts**
  - Increased demand
  - Reduced supply
  - Spike in natural gas prices
  - *But* availability from natural gas storage supplies

## CONSIDERATIONS AT EACH CUSTODY OR TITLE TRANSFER POINT

### IMPACTED PARTIES:

- Producers
- Marketers
- Gatherers
- Transporters
- Processors
- Downstream purchasers / end users
- Storage recipients / providers
- Hedge counterparties

### CONSIDERATIONS:

- Obligation to purchase or sell
- Force Majeure or other performance excuse
- Payment versus performance obligation
- Financial assurances triggers
- Mitigation obligations
- Hedging liabilities
- Bankruptcy considerations
- A single party could be in a different position at a different custody or title transfer point
- “Domino effect” through custody and title transfers points



# Lessons Learned

- Revisit your service/commodity contracts
- The case for a capacity market
- Other quick thoughts

# THANK YOU

**This content is intended for educational and informational purposes only. It does not constitute the provision of legal advice or services by any of the speakers or by Vinson & Elkins LLP.**

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