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Searching for Relief from the Headaches Facing the Merchant Power Sector

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Unlike their regulated counterparts, merchant power generators have increasingly struggled to compete over the last few years and the outlook for many is that this won't change any time soon. While regulated power companies often enjoy near monopolies in their respective markets, merchant power companies build out their power generating capacity on a speculative basis and then sell their output at competitive rates to unregulated markets across the U.S. This means that merchant generators need to produce not only the right amount of power, but the right amount of power at a competitive market cost.

This model has traditionally worked very well, but as we'll explore here, the industry has seen a number of recent bankruptcy filings among these companies, from small merchant providers to larger regional companies that have traditionally led their markets, and these conditions don't appear to be changing anytime soon. These changes question the future of merchant power generators, and the reason for this recent market shift boils down to the rise of renewables (such as solar and wind power), distributed generation and storage, flat demand growth, and low natural gas prices.

According to a recent report from Wilkinson Barker Knauer LLP and the Power Research Group, more than 40% of U.S. power demand is supplied by merchant generators rather than regulated utilities. But the issue with merchant power generators is their revenues don't typically cover what it costs them to produce the power and capital costs of operation. The report goes on to explain that flat demand coupled with growth in power generation capacity has been a recipe for disaster in the sector, leading to many bankruptcies.

For example, recent bankruptcies in this space include FirstEnergy Solutions Corp. (the unregulated power generation subsidiary of FirstEnergy Corp.), ExGen Texas Power, and Panda Temple Power. Competition among merchant power generators also drives power prices down to a fraction of what it costs them to produce, in turn negatively affecting their revenue and bottom line even more. A separate report from the Analysis Group "Electricity Markets, Reliability and the Evolving U.S. Power System" offers a similar outlook, explaining that the emergence of more-efficient gas-fired resources is driving natural gas prices down, while stagnant demand for electricity is negatively affecting the profitability of older merchant power companies in areas of the country with competitive wholesale markets.

The rapid growth of newer energy technologies and renewables has also reduced the profitability of merchant power companies. According to a recent Bloomberg report, in the first quarter of 2018 alone, the market saw more than $10 billion in new renewable investments. Many of these investments are part of a long-term trend in shifting to renewable power generation sources, driven by federal and state-level energy regulations, and an increased desire among customers for more renewable energy options. As long as this trend continues, renewable power generation will keep eroding the market share of more traditional generators and merchant facilities in the U.S., exacerbating the decline in use of fossil fuel power generation and adding another layer of headache for merchant providers.

Natural gas prices have remained low over the last year, according to data from the U.S. Energy Information Administration. These low natural gas prices depress wholesale electricity prices, and in turn, the average wholesale electricity prices at major trading hubs have declined significantly.

These challenging market conditions and economic factors impacting merchant power companies will eventually catch up to them when they need to recover their fixed supply costs, and they won't be the only losers in this scenario. Wholesalers, and the customers in communities that rely on them for their power, could begin to see higher and more-volatile power prices. They could also experience reliability issues in the future. So, while power markets may currently enjoy lower prices and exciting new renewable energy alternatives, the reality is stagnant demand and current natural gas costs are putting significant economic pressure on merchant power companies and the grids dependent on them.

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