North American Portfolio Power Deal of the Year 2008

02/03/2009

Topaz Power: Repowered up

The $1.2 billion financing for the repowering of the Topaz Power portfolio covers the refurbishment of an elderly set of power plants, and had to be reworked to clear the commercial bank market. It serves, then, as probably the best guide to how to get a deal done in 2009. Since banks are still extremely picky, and developing entirely new plants is still time-consuming, expect Topaz to have some imitators.

The owner of Topaz is the Carlyle/Riverstone Global Power Fund III, which acquired the portfolio from AEP in 2004 in conjunction with Sempra Energy. The crown jewel of the portfolio, the coal-fired Coleto Creek, was sold to American National Power, handsomely recouping the original purchase price. Part of the rest of the gas-fired portfolio, seemingly adrift as Texas moved to coal to fire its generation, was sold to NuCoastal, while Carlyle/Riverstone, which had bought out Sempra, kept the rest for their option value.

But Texas did not shift towards coal-fired generation. TXU, the utility that proposed a suite of coal-fired plants that would have squeezed gas-fired generators out, relented in the face of sustained public opposition. Other developers found themselves on the receiving end of protests from local politicians, who can normally be relied upon to support new plants.

The vacuum left by the departure of TXU, and TXU's acquisition by a private equity consortium, allowed Carlyle/Riverstone to revisit the gas portfolio. They decided to repower it, submitted permits for this work in April 2007, and in November 2007 mandated Morgan Stanley as financial adviser to work on a financing for the portfolio.

The assets have a nominal capacity of 1,403MW, although 552MW of this is mothballed, located at Nueces Bay on the north side of the Corpus Christi Ship Channel, the Barney M Davis complex, on the south side of the Corpus Christi Ship Channel, and Laredo, on the Rio Grande River. One of the plants, Barney Davis 1, is already operational, and has a capacity of 335MW in simple-cycle configuration.

The repowering involves the construction of two new units at Laredo, 4 and 5, each with a capacity of 102MW, using GE LMS100 gas turbines. It also involves the conversion of Barney Davis 2 and Nueces Bay 7 to combined-cycle units, each with a 680MW capacity. The combined cycle plants will use new gas turbines, but steam turbine equipment dating back to the 1970s.

The plants all dispatch into the Electrical Reliability Council of Texas (ERCOT) power pool, and would be exposed to spot market risk. The combination of Texan merchant risk and brownfield construction risk made Topaz the most complex power financing to come to market in 2008.

Morgan Stanley's first instinct was to look at financing the work in the term B market, or at least combine B loan and commercial bank loans. By December this approach looked unlikely to succeed, which meant that the sponsor had to rework the project to make it more appealing to banks.

The first change was to put in place an energy hedge on the project, with Morgan Stanley's Capital Group covering 70% of the portfolio with a short-term hedge Topaz was far from happy with the hedge, since its owners feel that if Coleto Creek was not hedged they would have realized much higher values when it was sold. Texas, which faces looming capacity shortages, could be experiencing drastic spikes in wholesale power prices in coming years, though Morgan Stanley, which hedges both combined cycle units and one peaker, will now capture much of the benefit from them.

The next change was for Morgan Stanley to bring in Dexia Credit Local, ING Capital and Natixis as lead arrangers and underwriters. The move prefigured the market's shift to club-style underwriting, and the banks were the loudest in demanding that the portfolio's output be hedged. Banks have since become much less tolerant even of a partially merchant risk profile, and their number and appetite have since diminished. But ING and Natixis now form the core of the floating club of banks that has coalesced around 2009's deals.

The debt breaks down into a $615 million six-year construction term loan, a $75 million revolving letter of credit with a five-year tenor, and a two-year $50 million construction letter of credit. Rounding out the financing is a high level of equity, at $591 million. The level partly serves to reassure banks and partly because the sponsors hoped to replace some of this with holding company debt. In June 2008 it was much easier to suppose that such subordinated lenders might come to back to market soon.

The leads' aim was to have banks as close to their hold levels as possible before syndication was launched. In response to reverse enquiries, Calyon and WestLB came in as subunderwriters, while Union Bank of California, in exchange for a collateral agent title, pitched in for $50 million. GE Energy Financial Services made a commitment of $100 million, and a commitment of this size allowed it take a much sterner line on pricing and business interruption insurance coverage than smaller participants might have. Pricing shifted up from 325bp to 350bp over Libor, more than reasonable given the project's nature. Fully contracted deals will be lucky in the post-Lehman environment to match these levels.

The sponsors addressed construction risk through engineering procurement and construction contracts with Zachry for the two combined cycle units, and leant on GE to provide stronger guarantees than usual for its new LM100 turbines. The LM100s, described as "peakers on steroids" offer potentially impressive performance and efficiency, but have not always met these expectations during their short lives. Complicating the syndication, a truck carrying one of the turbines crashed shortly before the bank meeting.

The financing closed on 14 May, and syndication was complete shortly before the end of June. The length of the process was a departure from the B loan market's norm, although, again, is now considered lightning fast. The deal had to compete against several other deals that closed in the middle of 2008, including Kleen Energy and IFM/ConEd. Post-crunch, it is easy to assume that deals would come to market further apart. Far from it. Three US deals loom on the edge of the fragile New York market.

Topaz Power Holdings
Status: Closed 14 May, syndicated 27 June 200
Size: $1.33 billion
Location: South Texas
Description: Repowering of gas turbine portfolio
Sponsor: Carlyle/Riverstone Global Power Fund III
Financial adviser: Morgan Stanley
Hedge provider: Morgan Stanley Capital Group
Lead arrangers: Morgan Stanley, Dexia, ING, Natixis
Sub-underwriters: WestLB, Calyon
Pre-retail commitments: GE Capital, Union Bank of California
Insurance adviser: Moore-McNeil
Market consultant: PA Consulting
Independent engineer: Stone & Webster
Lender and hedge provider legal counsel: Shearman & Sterling; Akin Gump (Texas)

Sponsor legal counsel: Dewey LeBoeuf (mandate since moved to Alston & Bird)