

# Kleen Energy: LICAP's heir

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Goldman Sachs has launched the \$1.15 billion construction financing for the Kleen Energy power project to retail syndication. The financing is a rarity in the north-eastern US, since it benefits from a strong contract with a local utility. But several quirks in the deal, including its construction risk mitigation and syndication approach, also set it apart from previous practice in the power finance business.

Kleen Energy is a proposed 620MW combined-cycle gas-fired project that can run on both natural gas and low-sulphur fuel oil. It is located close to Middletown, in the central part of Connecticut. Its developer is William Corvo, an industry consultant, who continues to be represented as a sponsor through his stake in White Rock Holdings.

The principal sponsor of the project is now EIF Group, through three of its power funds – United States Power Fund II LP, USPF II Institutional Fund LP and United States Power Fund III LP. The EIF funds own roughly 80-90% of the project's equity, while White Rock and the project's engineering, procurement and construction contractor, O&G Industries, own the remainder.

EIF's role is a familiar one, a provider of bulk equity and financing experience to projects with promising fundamentals but limited sponsor resources. It played similar roles in the Lea Power and Astoria Generating projects.

Kleen has been developed in response to a request for proposals from the Connecticut Department of Public Utilities Control, which was looking for ways to improve the state's electrical system reliability in the region, which is perched midway between the two large load centres of Boston and New York. NRG Energy's Northeastern generating plants, which are old and coal-fired, dominate the market.

The state RFP was unusual in offering a long-term capacity contract to interested developers. Spot markets dominate the New England Independent System Operator region, both for energy and capacity. However, both this system and a subsequent modification known as a locational installed capacity (LICAP) market, have proved to be poor ways of encouraging new capacity. The RFP, mandated by the state's 2005 Energy Independence Act, is designed to work around the ISO's procedures and LICAP, reduce grid congestion, and pass along savings from these charges to the state's consumers.

Developers with plans for roughly 20,000MW of capacity expressed an interest in the project, but the final two bidders were Kleen and a refurbished oil unit from NRG. Kleen won the bid, and with it a 15-year capacity agreement with local utility Connecticut Light & Power, part of Northeast Utilities. Kleen won in part because the nearest competitor proposed the refurbishment of a unit that already owned a reliability-must-run contract with the ISO.

The CL&P capacity agreement dispenses with many of the lender concerns with respect to offtake risk. NU is a well-regarded utility, rated BBB/Baa2/BBB (Fitch/Moody's/S&P), and can recover the cost of the capacity payments from its customers. The agreement is structured as a contract for differences, since CL&P will reimburse the project for any shortfall it suffers between a set price and the price it receives on the New England forward capacity market. The capacity payments account for 60% of the project's projected revenues, and are priced for an equivalent of \$13.40 per kW-month.

The project is also set to sign shortly a seven-year tolling agreement for the output of the project. No counterparty has yet been formally identified, but bankers familiar with the deal say that Constellation Energy Group has been under consideration. The shortness of this tolling agreement is the reason why the project could not have been financed in the bond market.

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The financing breaks down into a \$450 million construction plus eight-year term loan A, a \$315 million construction plus 14-year term loan B, and a \$250 million eight-year revolving credit. The revolver will be used to fund letters of credit, including \$50 million in favour of the EPC contractor, \$60 million in favour of CL&P and \$60 million in favour of the tolling counterparty. Following completion, the first will be cancelled and the second two sharply reduced.

Construction risk is probably the most difficult factor to mitigate. The project uses proven technology – Siemens STGT6-5000F turbines and Vogt heat recovery steam generators – and the EPC contractor is relatively well-known, though not a top-tier plant builder. O&G has guaranteed that the project will be in service by November 2010, and has posted a \$300 million performance bond. The financing also includes a \$89 million contingency on the \$760 million construction contract.

But the EPC contractor could deliver a plant with a slightly higher heat rate than the base case for the financing without paying liquidated damages. A higher heat rate would mean lower electrical output per unit of gas fed into the generator, and thus slightly lower margins than the model for the plant outlines. Under the base case, the project produces a debt service coverage ratio of 2.34x in 2010, dropping to 1.55x in 2017, before rising to 6.35x in 2024.

The difference between the A and B loans is not their security priority but their amortization profile. The B loan will amortize minimally before the A loan matures, though scheduled interest on the B loan must be repaid before principal on the A tranche. The A loan is priced at 175bp over Libor, and the B loan at 250bp. One contemporary deal, the Topaz Power repowering, is offering arrangers 325bp margins.

The lead arranger, however, is seeking to maximise interest in the loan by procuring a respectable BBB- rating from Fitch, offering 75bp fees for \$50 million commitments, and bringing in BNP, Dexia, HSH, ING, Natixis, Scotia Capital, UBOC and WestLB as lead arrangers. Commitments are due by the end of May.

Probably the most wounding criticism of deregulated power markets is that they have been unable to provide the price signals that would encourage new plant building. Not all of this criticism is fair, since ISOs have little power to encourage generous project finance lending. But the Connecticut RFP, and Kleen's subsequent financing, show what a well-judged government intervention can achieve.

### **Kleen Energy Systems, LLC**

Status: Launched to syndication May 2008

Size: \$1.15 billion

Location: Middletown, Connecticut

Description: 620MW combined-cycle power project

Sponsors: EIF Group, White Rock Holdings, O&G Industries

Mandated lead arranger: Goldman Sachs

O&M Contractor: North American Energy Services

Independent engineer: E3 Consulting

Design engineer: WorleyParsons

Permitting engineer: PB Power

State's consultant: London Economics

Developer legal adviser: Chadbourne & Parke

Project legal adviser: Bingham McCutchen

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