Sleeves and tricks

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In the United States, retail power and gas markets continue to grow, as increased consumption and generally higher prices create higher revenues for the industry. The country's power and gas markets are already large. According to the US Census Bureau, total revenues for the electric power industry in 2006 exceeded $324 billion, and total revenues for gas utilities in 2005 exceeded $96 billion (1).

These revenues, when paid under contracts, can be turned into assets available for financing. These assets are accounts receivable for delivered commodities, or receivables, and the stored value in above-market fixed-price contracts for future deliveries, or mark-to-market value. The mark-to-market value, together with receivables, can be expressed as contract value.

While this article focuses on retail energy companies, the financing principles described apply equally to wholesale energy companies and their contracts. In either case, the overriding difficulty in financing the contract value is that mark-to-market value can be or become negative depending on market conditions.

Traditional financing of contract value

The traditional form of financing for contract value in the energy industry is bank financing or bank-sponsored securitization, which in either case focuses on providing credit based on accounts, with deductions for any negative mark-to-market value that could be set off against the accounts. In the context of a retail energy company, this can create a financing shortfall, because the retail energy company's wholesale suppliers expect buyers to post credit in the form of cash or letters of credit that cover the wholesale supplier's entire exposure, both for the wholesale supplier's accounts from the retail company and for the energy company's mark-to-market obligations to the wholesale supplier.

This situation can be seen in the diagram below, where the energy company has $12 in contract value from the energy company's retail customer to cover $10 in exposure to the wholesale supplier, but the traditional bank financing provides only $8 in credit for posting to the wholesale supplier, the $8 being 80% of the receivable value, a typical lending discount, with no credit for the mark-to-market value of $2 in the retail contracts.

Because of this insufficiency, energy companies that lacked the additional assets to pledge to traditional banks to obtain additional credit sought to find a method to obtain credit for the residual value in the receivables not covered by the traditional bank's 80% of receivables lending base and for the mark-to-market value in their retail contracts.

One method was to arrange, with the consent of the traditional bank, a lien-sharing arrangement. In this type of sharing arrangement, the traditional bank would agree to provide a second lien for the wholesale suppliers, using as a base the documentation already in place providing for the traditional bank's first lien. These arrangements typically involve intercreditor terms that leave the wholesale suppliers without substantial control over the collateral package or substantial rights to take action to enforce the second lien.

As such, the bank is carrying on as before, while wholesale suppliers' concerns regarding the mark-to-market values associated with retail customers and wholesale suppliers remain. In the market, wholesale suppliers generally have not grouped together to force changes in the terms of such arrangements, although there has been commercial pressure from wholesale suppliers resulting in improved terms in a number of more recent shared first lien credit offerings.

Much work remains to be done in creating understandable and fair collateral sharing arrangements between banks and

wholesale suppliers. However, while that work remains outstanding, other lenders have focused on using project finance principles to quantify and stabilise the mark-to-market value held by energy companies so that greater credit can be given to energy companies for their contract value.

Credit sleeves and guarantees are viable

Critical to any project financing is the ability to quantify and monitor a project's performance. Since that principle also applies to financing an energy company's contract value, the ability to monitor the receivables component of contract value is generally available. Much more complex, and the key to providing increased credit for an energy company's contract value, is the ability to quantify and monitor the mark-to-market component. Banks and investment banks with established energy commodity trading groups and large energy commodity suppliers have the knowledge of contractual provisions and market capturing statistical models that enable them to understand and quantify mark-to-market values for an energy company. They also are able to update and monitor those values as new contracts are added and market prices fluctuate.

In conducting diligence, it is important to determine that termination provisions in the applicable contracts allow the capture of market value. It is equally important that those termination provisions are not capped with respect to exposure or subject to calculation based upon market values that would be difficult to prove in the event of an enforcement action, as well as the ability to maintain daily electronic reporting of contractual provisions and market prices to conclude net mark-to-market positions.

Project financings also pressure participants to stabilize the relationship between feedstock and other input prices and output prices. With respect to stabilising the mark-to-market relationships of an energy company so that changes in the market will not lead to deterioration in credit quality, the very nature of mark-to-market value means that market fluctuations create changes, so stabilization can only occur through the balancing of mark-to-market exposure across counterparties. In the example above, this balancing can be seen between the $2 mark-to-market value obtained from the retail customer and the $2 mark-to-market value owed to the wholesale supplier. This balanced book approach, assuming that counterparty credit quality is solid, can reduce mark-to-market risk substantially in the same manner that fixed-price inputs and outputs in a project finance and allow financing of the mark-to-market value (2).

A credit provider that is capable of quantifying and monitoring mark-to-market values and is capable of determining that balanced books are maintained is in the position to provide increased credit for the contract value of an energy company and not just the receivables component of that value. This increased value could be seen in the form of a borrowing base covering the mark-to-market component of contract value. However, more recently the market has seen credit providers interceding in the contractual chain between wholesale suppliers and energy companies and providing a credit sleeve, whereby transactions with wholesale suppliers are run through the credit provider.

This arrangement has two significant credit advantages for the participants:
(1) For the credit provider, the credit sleeve structure provides inherent knowledge of one side of the energy companies' transactions. Diligence in monitoring responsibilities is therefore reduced to tracking the transactions between the energy companies and their retail customers and inputting those transactions into the modelling software employed by the credit provider.
(2) For wholesale suppliers, credit monitoring responsibilities are substantially reduced. Wholesale suppliers look to credit providers for credit, usually based on a ratings agency's evaluation of the credit providers, not the implied remaining collateral value of a potentially unmonitored mark-to-market value held by an energy company. In addition to those credit advantages, there can be cost savings, as described in the below diagram reflecting the credit sleeve structure:

A variant of the credit sleeve is the credit guarantee transaction. In this structure, the credit provider does not insert itself into a position between the wholesale suppliers and the energy company, but rather provides a credit guarantee to the wholesale suppliers.

Some energy companies prefer this structure because, if properly structured, it can be easier to remove the credit provider at the end of the term as the remaining contractual relationships are maintained and only the guarantee need be replaced (3). Balancing this potential advantage is the potential disadvantage of having to establish and maintain separate wholesale supplier relationships, when, under a credit sleeve, the energy company gains access to the credit provider's wholesale suppliers.

Anatomy of a complex credit guarantee

While the key to the successful financing of the mark-to-market component of contract value may be to establish the balanced book, another project finance technique is applied to simplify the credit analysis in implementing most credit sleeve transactions. The technique involves structuring a transaction's vartious entities to move unwanted liabilities away from the financeable assets. That means structuring the entities holding contract value in such a way that the contract value and associated contractual obligations to suppliers are the only assets and liabilities likely to affect the entities' credit.

Other assets, such as personnel, systems, and the like, and associated liabilities, and investor debt or other obligations not related to the Contract Value, are typically moved to holding companies that enter into contractual relationships with the energy company that can be quantified and, in many circumstances, structurally or contractually subordinated.

A recent example of a large-scale credit sleeve using these techniques is Reliant Energy's recently completed credit guarantee transaction with Merrill Lynch, which, when completed, returned to Reliant approximately $1 billion in collateral postings that Reliant had outstanding to wholesale suppliers.

This transaction, as depicted above, reflects the application of several project finance techniques:

(1) Reliant's retail energy business has been ring-fenced from Reliant's corporate entities. As part of this ring-fencing, Merrill has a golden share, or non-economic limited purpose voting share, in the top retail holding company RERH Holdings which allows Merrill to vote on bankruptcy and other credit-sensitive issues. All obligations of the Reliant retail entities for Reliant's corporate obligations (for instance guarantees of Reliant's corporate notes) are terminated.

(2) The relationship between the Reliant parent company, Reliant Energy Inc. (in the diagram REI), and the retail companies is carefully designed and all relationships are represented contractually. These contracts include a master services agreement detailing the relationships between the REI's corporate service staff (administration, finance, and so forth) and the retail entities and trusts with appropriate licences detailing the shared information technology and intellectual property relationships. The bankruptcy remote trusts allow Reliant's corporate creditors and Merrill as the retail credit provider to be sure that appropriate intellectual property rights will be available as collateral in the event either the corporate entities or the retail entities suffer unexpected credit issues. Certain obligations under the documents between REI and the retail entities are contractually subordinated.

(3) Merrill provides a credit guarantee in the form of actual guarantees and tri-party credit support annexes to Reliant's suppliers, including RES, the Reliant corporate entity providing supply to the Reliant retail entities. The tri-party credit support annex operates with Reliant's ISDA-compliant trading master agreements, and provides Merrill with the contractual path to posting credit under circumstances when Merrill's guarantees alone would be insufficient (such as when a counterparty's other transactions with Merrill reach applicable credit thresholds). Any payments made by Merrill on behalf of Reliant are to be repaid to Merrill under a credit support and reimbursement agreement, the principal financing document for the transaction.

(4) Merrill provides a $300 million working capital facility to the Reliant retail entities in order to avoid a liquidity problem. The purpose of the facility is to manage cash flow lag stemming from timing mismatches between payment receipts from retail customers and payment due dates to wholesale suppliers. This feature reduces the overall risk profile for the Reliant retail entities.

(5) The supply relationship between Reliant's corporate supply entity RES and the Reliant retail entities is carefully

controlled. No more than 10% of Reliant's retail supply can come from RES, and all services provided between RES and the retail entities (for instance services related to the Channelview project) are carefully contracted.

Because of the size of the contract values outstanding in the energy industry, energy companies will increasingly look for credit for the mark-to-market component of their contract values. Transactions along the lines of the Reliant credit sleeve, and of an increasingly sophisticated nature, can be expected. While utilities have until now been the main beneficiaries of such structures, merchant generators and traders could also put in place such enhancements. Credit providers will place particular emphasis on increasing sophistication in monitoring and evaluating outstanding positions and trading activity. But counterparties will also need to show increased sophistication in understanding and implementing these financing techniques.

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Footnotes

1 US Census Bureau, Compendia, Table 916 and 921, See www.census.gov/compendia/statab/cats/energy_utilities.html

2 This same technique can be used in the context of hard asset energy financing arrangements, for example by requiring that all hedges provided by wholesale suppliers to an energy company to be secured under the energy company's collateral sharing arrangement secured by material hard assets operate such that the company's exposure under the hedges increases when commodity prices move in a manner that increases the value of the hard assets. Calpine's new right way risk shared first lien facility is an example.

3 While in concept the credit guarantee may be easier to remove than a credit sleeve, in either case the mechanics are complex and require careful evaluation.