Northeast Biofuels: Hedging bets

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Northeast Biofuels (NEB) closed financing for its 100 million gallons per year ethanol facility on 30 June. The financing comprised $217 million in debt arranged by Goldman Sachs, including an innovative multi-year crush spread hedge, and an equity investment by Permolex following backing from Citigroup Venture Capital. The plant is the first ethanol facility in the Northeast United States – because of its strategic upstate location it has low-cost access to markets representing over 2.3 billion gallons in ethanol demand both regionally and in Eastern Canada. It is the first deal to include this type of hedging arrangement and it received, by one notch, the highest ethanol rating yet from Standard & Poors and Moody's.

The NEB plant will be constructed at Riverview Park in Volney, New York on the site of a former Miller brewery. The existing infrastructure and equipment mean that the project benefits from lower construction costs. The plant is expected to be the third largest in the US, and will use roughly 41 million bushels of corn as a feedstock, 10 million of which is sourced from within the state. Perdue Farms will provide NEB with corn, and also be responsible for marketing the 367,000 tons of distillers dried grains co-product.

Goldman Sachs acted as sole lead arranger and placement agent for the credit facilities. The debt consists of a $140 million senior secured term loan, maturing in 2013, a $12 million senior secured working capital facility due 2011 and a $65 million senior secured letter of credit facility due 2013. The debt benefits from a hedging arrangement with Goldman's commodity trading unit J. Aron. This crush spread is similar to a spark spread, the difference being the input costs of grain and natural gas (ethanol plants' two most significant costs) versus the revenue from the outputs, ethanol and animal feed. J.Aron will guarantee a margin between what is paid for natural gas and grain and what is paid for the ethanol and animal feed. J. Aron buys the ethanol and animal feed at a price which reflects their expectations of prices for grain and natural gas. Essentially this hedge provides a stable, predictable stream of revenue during the first three years of the debt.

This type of hedging arrangement has been used in power deals, and the upsides of this arrangement for NEB are slightly more leverage and slightly lower pricing, as well as a better credit rating. NEB was able to obtain 70% leverage, instead of the 65% it would likely have received without it. The pricing, which ended up at 325bp over Libor, would likely have been 350bp over Libor in a merchant deal. Moody's rated the debt B1, whereas normally it would likely receive a B rating. S&P assigned it a B+ rating.

The downside of this arrangement is that in handing over some risk to J. Aron, NEB also handed over some of the potential benefit from wider positive margins, and commodity risk still exists later in the term of the debt. The arrangement goes out three years, but the debt has a tenor of seven years. By the end of the hedge, 50% will be paid off but the remainder of the debt is exposed to merchant commodity risk. This commodity risk is relatively stable now but is predicted to be greater in three years time, since predicting market fundamentals that far out is very difficult.

NEB put a letter of credit in place for J. Aron's benefit so that if the plant does not progress according to plan, then J. Aron is guaranteed repayment, since if the project did not happen, then the counterparty would have to buy the ethanol in the spot market and might lose money. The LC is pari passu with the senior debt in case of default. One banker close to the ethanol market says "essentially they are trading off commodity risk in the first three years with plant performance risk in the first three years. I'm not sure that the upsides that the equity got outweigh the potential economics that NEB gave away."

But the hedging facility was highlighted in Moody's B1 rating as a favourable aspect in that it provides a buffer with ethanol's unpredictable commodity market. In addition, Moody's listed governmental support for the fuel, including the New York state-level incentives and also the 2005 Energy Policy Act. New York and Connecticut are expected to use over 500 million gallons of ethanol in 2006, with northeast demand expected to rise to over one billion gallons per year

The areas of concern that Moody's notes include the uncertainty of ethanol demand, exposure to fluctuation in commodity prices beyond the J. Aron hedge, and a financial structure with high leverage.

Canada-based producer Permolex is now a co-owner of the project, and has raised equity investments from Brent Mackenzie Group and Citigroup Venture Capital (CVCI). CVCI is responsible for Citigroup's Sustainable Investment Program, which focuses on private equity investments in renewable energy. The pension funds of two local construction unions helped sustain the project for two years before financial close. The unions loaned NEB $3 million to keep the project afloat, and in return 400 members will work on the project.

Northeast Biofuels LLC
Status: Closed 30 June
Size: $165 million
Location: Fulton, New York
Description:
First ethanol plant in the Northeast US and the first to include a multi-year crush spread hedging arrangement. Received the highest credit rating in ethanol history.
Sponsors: Northeast Biofuels, Citigroup Venture Capital International, Brent Mackenzie Group, Riverview Business Park.
Debt: $217 million
Lead arranger: Goldman Sachs
Preferred equity: NYSCRF/ Hamilton Lane Advisors
Commodity Hedge Provider: J.Aron & Company
Legal counsel to CVCI: Cleary Gottlieb Steen & Hamilton, Blake, Cassels & Graydon, Loyens & Loyeff
Legal counsel to BMG: White & Case, Aird & Berlis
Legal counsel to RBP: Hancock & Estabrook, Caraccioli & Associates
Legal counsel to Permolex: Gowling, Lafleur &Henderson
Legal counsel to the lenders: Latham & Watkins, Baker & McKenzie
Equity adviser: Jeffries and Company
EPC contractor: Lurgi PSI.
Independent engineer: Luminate,
Market consultant: Informa Economics
Insurance consultant: Moore-McNeil
Geotechnical consultant: O'Brien & Gere Engineers
Technical consultant: ADF Engineering
Environmental consultant: EBA Engineering Consultants
Hedging consultant: Risk Capital Management Partners
Tax advisory: Deloitte & Touche