North American Refinancing Deal of the Year 2005

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The $320 million refinancing of the 240MW Crockett Cogeneration Power Plant, which closed in March, marked a spectacular return to investment grade for Californian qualifying facilities (QFs). The 144A bond issue, rated Baa3/BBB- by Moody's and S&P, priced at less than 150bp over its comparable Treasury – a threshold recent issuers such as FPL Wind and Neptune were unable to breach, despite having the same, or better, ratings.

As well as hinting at a return to health for the Californian power sector after its troubles at the start of the decade, the issue also produced a handsome dividend of more than $100 million for Crockett's owner – a limited partnership owned by three EIF-managed funds, GE, two ArcLight funds and Delta Power. The original bank debt, dating from 1999, was worth roughly $200 million, making the refinancing a rare negative equity transaction.

The tight pricing was partly down to luck with the timing, but it is also evidence of the capital markets' appetite for investment grade project debt. The challenge was getting the rating. For that, Crockett's owners and BNP Paribas, their financial adviser, had to convince the agencies that the plant's efficiency outweighed the risks posed by the thermal host's weakness and the return of short run avoided cost (SRAC) pricing in 2010.

EIF decided the time was ripe to refinance Crockett's debt when Pacific Gas & Electric (PG&E), the plant's offtaker, emerged from bankruptcy in April 2004. The plant had been operational since 1996 and had a solid operational history. A refinancing would free Crockett from the stringent covenants that bank loan funding places on projects; by issuing 20-year notes the tenor would also come into line with the length of the PPAs, which ran until 2026.

Most of the bankers bidding for the advisory mandate doubted an investment grade rating could be achieved, and instead suggested private placements with three or four insurers. The prevailing view was that no matter how well the debt was structured, it could never be rated better than two notches down from the power purchaser. PG&E emerged from bankruptcy with a Baa3/BBB- credit rating – two notches down from that would have spelled disaster for Crockett's Rule 144A aspirations.

But the sponsors were determined to press ahead with a 144A in order to get the tightest pricing available. With a regular placement, a small number of lenders would be able to dictate terms to the borrower. They were hearing figures of 200bp to 250bp from bankers – probably quoting more aggressively than what they really thought was possible.

Those banks that did back the 144A issue generally quoted figures in the 200bp to 210bp range, the best bid coming in at 185bp – a measure of how much the eventual outcome exceeded expectations. BNP Paribas won the advisory mandate and the work began in earnest in October 2004.

Crockett had many strengths that would help justify a Baa3/BBB- rating: output was fully contracted, meaning no exposure to merchant risk; healthy cover ratios, averaging 2x under base-case projections, with a minimum of 1.45x; a strong performance history consistently earned bonus payments for meeting availability targets; proven GE gas turbine technology; and an attractive heat rate relative to other QFs in California.

But the deal would stand or fall on whether the credit agencies could be persuaded that Crockett's QF status was secure. To be classified as a QF, a facility must fulfil the legal condition that it produces electricity as a by-product of some other economic activity – generating steam in the case of a cogeneration plant. Local utilities then have to buy the QF's entire electrical output at a discount to their avoided cost. However, if the plant has no steam host, it cannot qualify as a QF, which for Crockett could mean the cancellation of its PPA with Crockett and revocation of its lease by the state of California.

Crockett's weakness was the prospect of being left without a steam host. An offtake contract was in place with C&H, a local sugar refinery, which effectively ran for 21 years (C&H can terminate the agreement after 2011 but needs steam; under the terms of the contract it wouldn't be able to generate its own or buy from elsewhere until 2026). However, C&H was highly leveraged and its poor credit quality cast a shadow over the whole deal.

The sponsors hired independent engineer Harris Group to examine the possibility of building an alternative steam host in the event that C&H filed for bankruptcy. The study found that new a thermal facility, such as a water distillery, could be built in about eight to 12 months at a cost of around $4 million.

In two previous instances of QFs losing their steam hosts, the FERC had given them two years in which to find a replacement, setting a precedent that would probably be repeated if C&H went out of business. This was enough to convince the rating agencies that C&H's credit worthiness, though still a risk for the project, was an acceptable one at the BBB- rating, given the ease with which the steam host could be replaced.

The rating agencies also drew comfort from the fact that the C&H sugar refinery – founded in 1906 as California & Hawaiian Sugar Co – was a sound asset because of its location on the coast, where it received cane imports from Hawaii, Mexico and the Pacific Rim countries. It was also getting steam at a cheap rate from Crockett. Its problems stemmed instead from a leveraged buyout in the early 1990s that left C&H highly indebted. As such, a change of ownership seemed likelier than bankruptcy – which proved to be the case in August 2005 when American Sugar Refining bought C&H.

The exposure to SRAC price changes proved was less of a problem in getting an investment grade rating than might be anticipated.

Under the terms of the PPA, Crockett would not receive SRAC prices until 1 January 2010. Beyond that point, Crockett would only be exposed to SRAC price risk until 2011, when the gas supply contract with BP Canada expires – a new contract would link the gas price to SRAC.

That leaves a relatively short period in which Crockett would be exposed to potential mismatches between the price of its inputs and outputs. As the SRAC price is determined by the most efficient heat rate for the whole system, any mismatch could be beneficial for Crockett, which has good economies since it is the largest QF in California.

After the Baa3/BBB- rating was secured and a 144A placement could go ahead, the team working on the deal received a huge slice of good fortune before the bonds were issued. PG&E, which had emerged from bankruptcy almost a year earlier, had its rating upgraded to Baa1/BBB, at a stroke increasing Crockett's attractiveness to investors.

Such was the demand for the notes when they were issued in March that the bookrunner received orders for the bonds worth more than $1 billion. This heavy interest helped the bonds price with a coupon of 5.89%, just 140bp over the 10-year Treasury.

The debt was sized with an ADSCR of 2x, enabling the sponsors to raise $295 million through the bond issue. A letter of credit facility from BNP Paribas accounts for the remaining $25 million debt.

The price was much lower than BNP Paribas and Crockett's owners expected. With their $100 million windfall they have probably extracted as much value as they can from the plant; Crockett's future over the next 20 years is now likely to be as a reliable, but low yielding asset.

This change was reflected at the end of 2005 by a period of trading shares between Crockett's owners, leaving GE Energy as majority owner with 53%. ArcLight and Delta have exited the project, EIF's funds now own 38.6%, and Osaka Gas owns 8.4%.

Crockett Cogeneration
Status: Closed 17 March 2005
Size: $320 million
Location: Crockett, California
Description: Refinancing of $200 million project
Sponsors: Energy Investor Funds Group, GE Company, ArcLight Capital, Delta Power
Debt: $295 million 144A bonds, $25 million L/C facility
Ratings adviser/Bookrunner: BNP Paribas
Legal adviser to the sponsors: Thelen Reid & Priest
Legal adviser to the lenders: Milbank Tweed
Independent engineer: Harris Group
Fuel adviser: MRW Associates
Sugar adviser: LMC International
Insurance adviser: Moore-McNeil