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The more things change...

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US power bankers are much more cheerful than they have been in several years. A number of banks are hiring new staff, and some institutions are expanding out of niche products and into general power finance. Investment banks are devoting more resources to the sector, if only to enhance their profitable trading operations.

Since bankers returned from holidays in early September, there have been several leveraged acquisition financings, as well as some refinancing, and one restructuring. All of these have been achieved on terms that, while frequently less attractive than the 1999-2000 boom years, are much better than would have been expected two years ago.

But these financings are likely to prove temporary, designed to hold owners and lenders over until a clearer picture of power prices and the regulatory environment emerges. The current continued low pricing on deals – some have come in as low as 200bp over Libor – might obscure this reality, but further refinancings are likely.

The Energy Policy Act, which President Bush signed in August, proved to be much more of an opportunity for the power industry than the declaration of energy independence promised by its proponents. The Act can be seen as a bag of subsidies for technologies as diverse as coal, wind, nuclear and ethanol. It also has several incentives to encourage transmission siting, as well as its operation separate from incumbent utilities.

But the most far-reaching effect of the Act, and the one most germane to the future of the independent power industry, is what it does to federal oversight of the electricity industry.

The Federal Energy Regulatory Industry has gained broad approval powers in terms of the siting of LNG and transmission facilities, as its chairman, Joseph Kelliher noted in Project Finance's Power Report. But FERC also looks like assuming wider powers in terms of enforcing reliability standards, discouraging market power and assuring price transparency. These could, theoretically, improve the prospects for several inefficient plants located near load centres, as well as more efficient plants located in the service territories of hostile utilities.

The most eagerly-awaited of FERC's judgements concerns the approvals required to transfer plant ownership. FERC approval is normally required to ensure that buyers do not gain market power as a result of their acquisition of new assets. This process was relatively painless, and relatively necessary, in the 1990s, when unregulated subsidiaries of utilities began buying plants from other utilities.

Now, ownership of plants in which equity investment has been written off rests with the holders of their project debt. These holders are largely an assortment of hedge funds, many of which would like to move in and out of their investments as painlessly as possible. FERC is currently considering whether to waive some of the necessary permits, as well as deciding on the permissibility of debt for equity swaps.

Boston G party

The issue is likely to come up in the case of the Boston Generating portfolio, the subject of a recapitalisation that closed on 23 October. BostonGen is a 3,405MW portfolio of oil and gas fired capacity located near Boston, Massachusetts. Its operational, financial and ownership history is convoluted, but the only way to summarise it is that one of the original lead arrangers of the project's debt completed a restatement of that debt for owners led by a new venture from the management of the original developer.

10% of BostonGen's equity is in the hands of K Road Ventures, formed by William Kreigel, former CEO of Sithe Energies, which developed the assets. K Road uses its familiarity with the assets to guide them through the approvals necessary to make them economic. This will require a real familiarity with the workings both of the FERC and the state regulators and the regional system operator.

BostonGen is fully merchant, and its economics, which are dependent on the meagre spark spreads (the difference between fuel costs and power prices) available to regional generators, shaky. But if it gains FERC approval for a reliability must run contract, and it has already been designated as essential to system reliability by New England's ISO, its economics would be much improved. (For more on the assets, search for "Sithe Boston" at www.projectfinancemagazine.com, and see the Deal Analysis this issue).

Merchant mavens

The only equivalent financings to close recently have been the KGen portfolio, a $475 million financing for a 5,300MW merchant portfolio formerly owned by Duke Energy, and the refinancing of Calpine's Metcalf project, a $255 million two-lien debt package for a 600MW gas-fired project in California. But Metcalf's sponsor, more than its location (which has very attractive fundamentals), was the main source of uncertainty on the latter, and the KGen portfolio had a small contracted portion, and was designed to be largely liquidated.

Boston Generating is, however, a work in progress, its owners still have a perceptible amount of uncertainty to confront. Other recent financings have been a little more straightforward, the most obvious being Complete Energy's financing for La Paloma. In La Paloma's case, the hedge fund owners decided to sell the plant outright to Complete, a start-up funded through investments from CIT, TCW and Engage Investments.

This deal, too, was initially pitched as a seller financing, whereby the hedge funds that bought into the distressed debt would remain as lenders to the restructured project. But La Paloma was tweaked heavily, partly through a new $523 million debt issue led by WestLB and Morgan Stanley, but also through a contract. WestLB, the adviser to the buyer, brought in Morgan Stanley Capital Group to provide price support to the asset, a 1,022MW plant located in Kern County California.

Such enhancement has been a familiar presence in many financings for assets in middling markets – those where a reasonably sophisticated trading desk could probably find value, but a lender might struggle to make debt service. Calpine has been a frequent user of such contracts, which often more resemble financial instruments than physical delivery of power.

The financial institutions have been making impressive profits from their commodities groups and trading groups. Merrill Lynch and JP Morgan Chase both attributed strong third quarter 2005 results to their commodities businesses. Merrill recently bought the Entergy-Koch trading operation, to replace the trading unit that it sold to Allegheny Energy in 2001. Bear Stearns has formed a joint venture with Calpine to market power, and Lehman Brother has moved over one of the co-heads of its power group, Frank Napolitano, to originate power trades.

Such contracts have by now become the driver of investment banks' involvement in energy financings, although their debt capital markets and corporate finance bankers have often denied this. Nevertheless, a hedging agreement with an institution normally requires that such an institution be appointed as debt underwriter. This is not usually a bad bargain – the banks with the best trading operations often have the best lists of potential debt buyers.

NRG back with big buy

The most prominent example of this approach has been the Texas Genco portfolio financing. In this deal, Goldman Sachs put together a short-term hedging arrangement for a 11,000MW (net), largely baseload, portfolio located in Texas, advised the buyers and was also among the debt underwriters. Citigroup and Deutsche were also among the arrangers, as was Morgan Stanley, which is understood to have picked up some contractual business in the aftermath of the financing.

The owners, Blackstone Group, Hellman & Friedman, Kohlberg Kravis Roberts and Texas Pacific Group, less than a year after raising $2.8 billion in financing, have sold the assets. The buyer is another familiar name – NRG Energy. NRG is offering to pay $4 billion in cash, $1.8 billion in stock, and assume its $2.5 billion in debt. The sellers paid $3.65 billion for the portfolio in 2004.

NRG's resurgence is particularly surprising, since it emerged from bankruptcy in 2003 and the acquisition doubles its size. NRG's equity is traded, although its owners largely consist of the hedge funds that owned a large proportion of its defaulted bank debt. The assets are located close to its existing Louisiana portfolio, and are less reliant on gas than much of NRG's fleet.

The buyer has mandated Morgan Stanley as lead arranger, joint documentation agent and bookrunner, and administrative agent, with "left side designation" on the term sheet, according to an 8-k form filed with the Securities and Exchange Commission. Citigroup, relegated to the right, takes the co-documentation, joint lead arranger, joint bookrunner and syndication titles. The two have provided a commitment to underwrite the transaction, which should close in the first quarter of 2006. The approvals process will be longer than normal because of the proportion of nuclear assets in the portfolio, as well as the size of NRG's existing portfolio.

The financing, according to the commitment letter, would consist of up to $3.2 billion in seven-year senior secured first priority term loans, a five-year senior secured first priority revolving credit of up to $600 million, and a five-year synthetic letter of credit of up to $1 billion to support the portfolio's hedging arrangements. The term loan and LC are priced at 225bp over the Eurodollar rate, or 125bp over the base rate (at the borrower's option), if the rating of the portfolio is Ba3/B- (S&P/Moody's), and 250bp/150bp (Eurodollar/base), if the portfolio is below that rating level. The margins on the revolver are 25bp lower than their equivalents for the term loan.

The final part of the financing comes from the issue of $3.6 billion in senior secured notes issued under rule 144A, and $1.5 billion in equity or equity-linked securities. The borrower is raising $5.1 billion in bridge loans, again through Morgan Stanley and Citi, which carry margins of 500bp over the Eurodollar rate, or 400bp over the base rate. The capital markets issues will replace this bridge loan.

Market watchers are sceptical about the valuation attached to the assets, a scepticism that might be encouraged by NRG's past form in overpaying for its purchases. NRG might have emerged from bankruptcy as a keen buyer of distressed assets, rather than a growth-crazed merchant producer, and has even qualified for Fresh Start accounting treatment. But the premium over what the sellers paid is steep, and probably does not indicate the graceful withdrawal of financial players from the power business.

Nevertheless, the turnover of players is cause for comment. EIF Group has liquidated one of its earlier funds, which owned stakes in the Crockett project among others. Arclight has also disposed of some assets – the Fort Point portfolio – to Osaka Gas. Perennial Power, part of Sumitomo Corporation, and Diamond Generating, part of Mitsubishi, are also looking for assets. Diamond recently mandated Fortis to provide $60 million in financing for its purchase of the 177MW Morris peaker in Illinois, and Perennial bought a stake in the Hermiston project from bankrupt PG&E NEG at the end of last year.

Contracts pay dividends

The Japanese players could probably, depending on their appetite, emerge as credible buyers of contracted assets from private equity funds. They have a relatively low cost of capital, and little interest in merchant power, so they are unlikely to grow into large-scale genco operations. Even the larger assets will present difficulties.

The larger contracted assets are attracting players with deeper connections to the banks and longer histories. LS Power recently completed the refinancing of the Kendall plant, a project that it had developed, sold to the old NRG, and then bought during NRG's bankruptcy. The deal, led by CSFB, consisted of $422 million in debt, broken down into a $412 senior secured million term loan with an eight-year tenor and a $10 million revolver due 2011.

This deal was notable for having a slightly longer maturity than a normal B loan – eight years rather than seven – and for its relatively high level of leverage. The challenge for the arranger involved maximising the leverage on an asset backed by contracted cashflow from low-rated Dynegy (mixed with slightly better cashflows from Constellation. Constellation stepping in to backstop Dynegy helped, as did LS' familiarity with the asset.

The debt refinanced the outstanding $441 million in loans on the 1,100MW plant, located to the south of Chicago. The original deal – a $554 million, seven-year miniperm, led by CSFB – was due to mature next year. The arranger suggested in 1999 that the project would have been a good candidate for a bond refinancing, but Dynegy's credit has not made this possible. But Kendall does, at least, have an uncontracted third unit, which is designed to cover for outages at the contracted units and produce surplus power for merchant dispatch.

Plants with a strong offtaker will find the bond market attractive, however. In September the owners of the 240MW Crockett Cogen plant – EIF, ArcLight and Delta Power, closed a $295 million private placement through BNP Paribas. This deal refinanced $202 million in bank debt, had a 20-year maturity, and priced at 140bp over the ten-year Treasury for a coupon of 5.869%.

Crockett could raise money on these terms since it has been operating since 1994. It has a power purchase agreement with Pacific Gas and Electric, once bankrupt, but now back to investment grade, and is the largest qualifying facility in northern California. The result of the refinancing allowed the sponsors to pay themselves a healthy dividend, and EIF to sell a majority stake in the plant to GE for a healthy return.

Who's left when the music stops?

Since ArcLight has also sold its stake on to Osaka Gas, the remaining player from before the financing is Delta Power. Delta, a dedicated owner-operator, also took a stake in Juniper. Such players have yet to demonstrate, however, that they can make solo tilts at the largest assets.

There may be a convincing rejoinder if US Power Generating (USPG) and Madison Dearborn can complete their purchase of Reliant New York's assets. The proportion of the equity to be contributed by the two has not been confirmed, but it is likely to involve a more substantial role for USPG than that played by K Road or players such as Tyr Energy, an Itochu subsidiary that bought 10% of the 672MW Lincoln generating project in Illinois. Along with ArcLight, thanks to a $143 million B loan from GE.

Reliant New York is a $975 million deal, and the buyers have already mandated four banks – BNP Paribas, Goldman Sachs, Merrill Lynch and Morgan Stanley – to provide a B loan split into first and second lien pieces. Morgan Stanley will provide short-term hedging arrangements for the assets – Gowanus, Astoria and Narrows – which consist of baseload and peaker units located in the outer boroughs of New York (for more on the assets, search by name at www.projectfinancemagazine.com).

US Power Generating is best known as the start-up founded by Jay Worenklein after his departure from SG, where he was global head of project finance. Worenklein is not the first former project finance banker to pick up assets – Chase's Bill Rockford at Primary Energy is worth a mention here – but he is the most high-profile, and the agreement with Reliant is the first for USPG, following an abortive move on the Lake Road plant.

Talking to Project Finance, Worenklein rejected suggestions that the price was too high, noting that the plants are in a very competitive position, and that New York's rules governing generation mandate that 80% of the city's needs must come from within its boundaries. Moreover, grumblings from some of the analysts that cover Reliant stock have suggested that it might have been able to get a better price. Reliant booked a $160 million loss on the sale, although the price is much higher than the $550 million that Orion (later bought by Reliant) paid consolidated Edison for the plants.

But the ability of the plant's new owners to get a lucrative contract on the Astoria project (the two peakers already have reliability 'must run' contracts) will be key to gaining attractive financing terms. The recent refinancing of the Astoria project – a $515 bond issue led by Calyon for a new gas plant in Queens – had to overcome construction risk and a short power purchase agreement with ConEd.

The above examples give some indication of why US power bankers are less free with their resumes than last year. Deal flow is strong, although in all but a handful of the financings described above, the refinancing risk, and the most stable capital structure for power assets, has been kicked down the road. While markets – and the regulatory environment – remain in a state of flux, this is likely to be the best that participants could hope for.