La Paloma: The circle is Complete

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Complete Energy has closed the acquisition of the La Paloma power project, using a B loan from Morgan Stanley and WestLB. La Paloma, an efficient gas-fired asset located in California, has witnessed several changes in ownership over the last three years, from developer, to banks, to Complete Energy. It has also witnessed several changes in financing structure – from project lease, to corporate asset, to seller financing, to project B loan.

La Paloma is a 1,022MW four-unit combined cycle gas-fired power plant located in Kern County, California, 40 miles west of Bakersfield and close to some of the growing population centres in the middle of California. It uses Alston GT24 turbines, which had experienced problems reaching their promised capacity, but are now reaching impressive efficiency levels.

The developer of the plant was PG&E Corporation's National Energy Group, the merchant energy offshoot of the North Californian utility. The NEG was known as an assiduous user of project finance, and also pioneered the use of synthetic leases. La Paloma was the second of its assets to be financed using a project synthetic lease – the first, Lake Road, closed in 1999.

La Paloma was also one of the earliest recorded instances of the use of a Term B loan in project finance, since its $730 million financing included a $295 million B loan, as well as $374 million in commercial paper, funded through a conduit managed by lead arranger Citibank. But the deal had to be unwound in 2002 in the aftermath of Enron, and NEG filed for chapter 11 bankruptcy protection in July 2003.

The project, which was not yet complete at the time of the filing, was ultimately handed back to its lenders, led by Citi as agent bank. By early 2004, the banks had started foreclosure proceedings, although several of them had sold on their commitments to dedicated distressed loan funds. The new lenders hired Lehman Brothers to conduct an auction towards the end of 2004. Complete Energy, which hired WestLB as adviser during the sale process, entered into exclusive negotiations with the lenders from March 2005.

Complete is led by two former Allegheny Energy managers – Lori Cuervo, former head of strategic planning and Peter Dailey, head of mergers and acquisitions – and two former Dynegy managers – Hugh Tarpley, former head of M&A and Milton Scott, former chief administrative officer. Complete's only asset so far is the 837 LSP Batesville plant, which it bought from NRG Energy.

Complete's original plan was for the sellers – the holders of the existing debt – to continue to lend to the project, in a form of seller financing. But the roughly 30 funds that held the debt wanted to be taken out with an entirely new deal, and so Complete needed to bring in fresh debt and equity. More importantly, it needed to work on the credit of the asset.

Two of the units at La Paloma (totalling 480MW) have power purchase agreements with Southern California Edison until 2007. The plant can dispatch into both the north and south of the state, and can operate flexibily. The project has also signed a tolling agreement with Morgan Stanley Capital Group to use a third unit from 2005 through 2012, and to use the two Edison units from 2008 to 2012. The two agreements, according to Moody's, cover 68% of the operating margin through 2012.

The Capital Group toll brought with it Morgan Stanley as a lead arranger of the debt, which took the form of first lien and second lien term loans. The first lien facilities consisted of a $244 million seven-year term loan B, a $21 million delayed-draw seven-year loan, a $40 million synthetic letter of credit and a $65 million working capital revolver. The second lien piece – a $155 million term loan C – is due in 2013.

The financing also includes a $120 million in equity from Complete Energy and six of the plant's original creditors, while Complete's share is funded through a holding company loan from CIT and TCW. Complete also benefits from a corporate equity investment from Engage Investments, the private holding company of the Erving Wolf family. It uses Power Plant Professionals and Fulcrum as plant managers (DTE had originally managed the plant for the banks).

The nearest benchmark financing to La Paloma was Coleto Creek, a coal-fired plant bought by Carlyle/Riverstone and Sempra Energy in 2004. Coleto was a coal plant located in Texas, but the concepts behind its financing – a B loan structured using project finance language to achieve the lowest price possible, was comparable. According to Milton Scott, "most of our financing decisions were based on achieving the lowest debt cost possible. If we could replicate the structure on future acquisitions we would."

The initial price talk on the debt was 200bp over libor for the first lien piece and 400bp for the second lien, but the deal ultimately came in at a lower level. The first lien piece, which was 1.5x oversubscribed, is priced at 174bp and the second lien – 3x oversubscribed – at 375bp. The deal was rated at Ba3/BB- (Moody's/S&P) for the first lien and B2/B for the second lien. S&P assigned a 1 recovery rating to the first lien piece and a 5 to the second lien.

The financing was not quite a merchant standout – as the recovery rating indicates, much of the debt will be covered by capacity payments under the contracts. But Complete and its holding company lenders do bear a fair degree of spot market risk. Still, as Complete's Scott notes, "California imports 40% of its power and this asset is in a great location. 175bp pricing says that the loan market agrees."

La Paloma Generating Co
Status: Closed 16 August 2005
Size: $643 million
Location: California
Description: Financing for the purchase of 1,022MW gas-fired plant from its creditors
Sponsor: Complete Energy
Debt: $523 million
Equity: $120 million
Lead arrangers: WestLB, Morgan Stanley
Borrower financial and ratings adviser: WestLB
Seller financial adviser: Lehman Brothers
Equity funding: TCW and CIT
Sponsor legal: Vinson & Elkins
Arranger legal: Latham & Watkins
Seller legal: Milbank, Tweed, Hadley & McCoy
Equity funding legal: O'Melveny & Myers
Operations: Fulcrum