New market money

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The influx of investment into US power has been fuelled by a range of new investors. Private equity firms, investment banks and hedge funds have joined IPPs and utilities as major investors. The uptick in investment has created interesting challenges and opportunities.

Over the past several years, primarily in an attempt to realign balance sheets, many independent power producers (IPPs), such as Calpine and AES, have sold assets, refinanced or paid down outstanding debt and restructured balance sheets.

Most of the asset sales by IPPs to date have involved contracted assets (where long-term power sales and fuel supply agreements were in place). Investment in merchant power is a riskier proposition for IPPs, particularly those with thinner capitalization. With no certain offtake arrangement or revenue source for the project, the IPP risks waiting a long time for a return or having any carried equity lost or reduced in the event of a future sale, restructuring or recapitalization.

In lieu of new investment, many IPPs are seeking to capitalize on years of operational expertise that is now in high demand from some of the industry's new players. IPPs are seeking partnership opportunities with these new market participants.

Delta Power Company, based in Morristown, New Jersey, is an example of an IPP looking to grow in this market. Delta Power owns and or manages 28 gas and coal-fired projects in the United States. Historically, Delta Power has invested in plants with contracted assets. However, as the price of many contracted assets has been 'bid up' in the current environment, Delta Power is re-examining its investment strategy. In recent years, the company has focused increasingly on operations and management. Dean Vanech, the President of Delta Power, thinks that the time to consider investing in the merchant plant market may arrive soon. "Over the next year or two, if the financial players that have purchased or inherited merchant plants are unable to move some of their product they may get restless and begin to exit the market. This could create buying opportunities."

Private equity

In the last several years, private equity firms have been very active in purchasing generating assets. Texas Pacific Group, Kohlberg Kravis Roberts & Co., the Blackstone Group and the Carlyle Group each possess sizeable generation portfolios. High quality boutique energy funds have also raised large amounts of capital focused on purchasing interests in power plants, transmission lines, fuel distribution and storage assets and renewable sources.

Private equity investors typically view their power investments with a 3- to 7-year time horizon, which gives them sufficient opportunity to provide added value to the structure of a project. Exit strategies optimize return, and usually involve an outright sale of the project interest, some kind of going-public transaction or recapitalization in which the private equity firm is taken out. The focus for most private equity funds has been on acquisitions of quality assets involving offtakers with acceptable credit ratings. These purchases have often been very competitive because of the high quality and consistent cash flow of the assets and the resulting ability to leverage the projects.

One of the first premiere energy funds is ArcLight Capital Partners. ArcLight has raised over $2.5 billion in two funds over the past three years. ArcLight's investments include projects ranging from electric generation units and gas storage facilities to wind turbines. According to Dan Revers, managing partner and, along with Robb Turner, a co-founder of the company, the process of deregulating and restructuring this complex and capital intensive business, coupled with inevitable commodity cycles, has created a unique opportunity for sophisticated investors. ArcLight's investment strategy also includes partnering with experienced management teams.

Hedge funds

Because they are largely unregulated, it is not clear exactly how many hedge funds are dedicated to the energy sector. Most observers believe that the number is at or near 100 and climbing. As returns in the energy sector reportedly approached 40% for some hedge funds in 2004, and as returns elsewhere tended to be well below 10%, yield-hungry hedge funds have been increasingly turning towards energy investments.

Hedge funds tend to hold assets that are highly liquid. Unlike private equity firms that are obligated to return money to their limited partners every 5 to 7 years or so, many hedge funds return money to their investors yearly. Typically, hedge funds have acquired interests in projects via distressed debt purchases as banks and other institutional investors holding interests in defaulting projects have sold the project paper.

However, distressed debt is not the only play by hedge funds. Many market players took notice when Cerberus Capital Management, Caxton Associates and Seneca Capital nearly won the auction for Reliant's Texas Genco assets, which were ultimately purchased by KKR Blackstone, Hellman & Friedman and Texas Pacific Group in July of 2004. This nearly successful bid by hedge funds to purchase hard assets may signal a fundamental shift in the role of such funds in the marketplace.

While hedge funds have traditionally appeared to be less interested in assuming management responsibility, as they come to own more equity interests in projects, they may start playing a greater management role.

Investment banks

Credit Suisse First Boston and Merrill Lynch have developed energy trading operations and have publicly stated that they plan to enter energy markets more aggressively. However, few investment banks have acquired a critical mass of energy facilities with the stated purpose of owning them long-term. Most investment banks do not have experience owning and running plants.

On the other hand, some investment banks are leveraging their skills in capital structure and financing, and their excellent credit and liquidity, to make longer-term investments in energy assets and to support trading operations. Goldman Sachs is one such player investing heavily in power generating facilities.

Over the last six years, Goldman Sachs has purchased many plants, beginning with its Orion Power joint venture with Constellation Energy Group in 1998, which purchased 81 power plants. In 2003, Goldman Sachs purchased El Paso's Linden, New Jersey project and acquired interests in dozens of qualifying facilities from El Paso and through its acquisition of Cogentrix.

More recently, in January 2005, Goldman Sachs purchased four gas-fired facilities, seven coal-fired facilities and a 5% stake in Iroquois Natural Gas Pipeline from National Energy & Gas Transmission. Morgan Stanley, in addition to its strong presence in the energy trading markets, is now a major owner of hard assets such as home heating oil, jet fuel and fuel storage facilities and electric generating assets.

Both Goldman Sachs and Morgan Stanley are utilising their expertise and balance sheets to coordinate investments to support trading operations and, conversely, to utilize trading to sustain and support such investments.

Commercial banks and institutional investors

While some institutional investors, such as GE Commercial Finance, continue to invest in the US power industry, others, including many insurance companies and commercial banks that had actively participated in the US project finance market, have reduced their investments. Many of these investors have sold positions to reduce exposure in the sector or have sold interests in defaulted projects. In cases of orderly dispositions of interests in defaulted projects, banks will usually look to find a buyer at the right price. In the interim, however, banks may benefit from an appreciating market. As the market improves, and as loan portfolios are rebalanced, it will not be surprising to see a substantial increase in activity from these investors.

In addition, some financial institutions are investing in the sector by participating in the growing Term B market. Recent project financings have witnessed a shift, especially with respect to merchant power, away from the long-term debt associated with traditional project lenders. The Term B market, which usually offers floating rate obligations over the course of 3 to 10 years, delayed principal amortization, low pre-payment penalties and less restrictive covenants, may be a more appealing alternative to both investor and borrower.

Investor-owned utilities

Many investor-owned utilities have refocused on rate base in the last few years, and, in the process, have reassessed non-regulated functions. The recent announcements of the Duke-Cinergy and Exelon-PSEG mergers and the purchase of Pacificorp by Warren Buffett's Mid-American Energy, suggest that rate base growth may be more readily achieved via corporate acquisition.

Other investor-owned utilities such as DTE Energy Company are continuing to grow by acquiring distinct asset types. According to Mark Rigby, Chief Financial Officer of DTE Energy Services, the unregulated subsidiary of DTE Energy, "we are still aggressively pursuing plants with contracted offtake or other smaller non-contracted assets, particularly in the renewable sector."

Another growth area for some utilities and their subsidiaries has been energy trading. Both Constellation Energy Group and DTE Energy Trading have contributed substantially to the bottom line of their parents.

Conclusion

The liquidity provided by private equity and hedge funds, and the current merchant plant overhang, continue to alter the landscape of investment in the US power market. As the number and type of investors changes, the various market players will continue to position themselves to optimize their strengths to succeed and grow in this evolving environment.