Teton Funding: Term B goes project

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ArcLight Capital Partners is close to completing financing on its $295 million acquisition of Aquila's Jamaican generating assets arranged by Lehman Brothers. The deal is one of the first large-scale transfers of contracted assets in the sector. As back-to-basics becomes the favourite slogan for the CEOs of overstretched utilities, further sales - and financings - look probable.

ArcLight is a private equity shop founded in 2001 by managers from Berenson Minella, McManus & Miles and John Hancock, among others. It first gained industry interest in the market as a partner with Aquila on the Lodi gas storage facility, on which UBOC and DZ Bank launched a $60 million financing. This fell through as Aquila's credit troubles grew.

As Aquila's star fell, ArcLight's rose - it stepped up to complete the acquisition on its own, and has since been highly acquisitive. Aquila, once part of the pack chasing Enron in the merchant energy sphere, has shrunk back to its core of utility operations, and has been the subject of a hard fought $640 million refinancing (see Project Finance, May 2003). It retained Lehman Brothers in 2003 to look for a buyer for some of its generating assets.On 12 November 2003, ArcLight agreed to buy the 643MW portfolio, which initially included interests in 14 plants, but was later reduced to 12 as a result of joint venture partners exercising their rights of first refusal. The sale fetched $300.9 million, and was struck through the Teton Power Funding vehicle. Lehman had offered to arrange a financing package for interested buyers.

Lehman's history with ArcLight, however, goes further than this, since it was one of the fundraisers for ArcLight's first fund. And given that the $300 million price was a large one for ArcLight to digest, it began looking at a debt financing at the end of 2003. The portfolio included Aquila's better assets, and excluded its peakers and at least one plant enduring a restructuring, but carried with it significant structural challenges.

The Teton portfolio is interesting in being a collection of project financed assets of varying types and credits. Indeed, as one banker puts it "the plants here give you an idea of the evolution of power finance over the last 15 years. We have everything from big public deals such as Selkirk, GE single investor leases, old school bank debt, and private placements with people like PruPower." Given the complexity of the financing arrangements of some elements of the portfolio, an acquisition financing would need to be laid over the assets as unobtrusively as possible. And given that the assets were subject to existing project-level debt, lenders would need to be subordinated.

But the complexity of the credit, and the diversity of the portfolio, meant that an approach to the high-yield market, the traditional home of financings based on project dividends, would be difficult. The solution Lehman settled on was an approach to the Term B market. The loan and hedge funds that play here are often staffed with ex-bankers, and have been common in corporate deals, including Aquila's refinancing.

But Term B loans are characterized by watertight and uncomplicated collateral packages, minimal operational covenants, and high interest rates. Teton was an attempt to get such lenders to look at a deal that was subordinated, and tightly priced. This was ArcLight's first time in this market - its recent Trout Coal financing, through CIT, Prudential Capital and GMAC, among others, was a private placement.

For this deal, the lenders have been persuaded to accept Aquila's, now Teton's, shares in the various projects as appropriate security. They also need to do the requisite project-level analysis to determine whether there will be sufficient excess cash available after debt repayment. The projects are attractive since they are largely old qualifying facilities with solid power purchase agreements. These run from between 2005 and 2037, with a varied group of utilities. All of the offtakers, with the exception of PG&E, are investment grade. The plants are concentrated in the states of Florida, Maine, California and New York. The hydro facilities serve a group of steam hosts that include snack maker Frito-Lay and juice maker Citrus World.

Moreover, several of the projects' debt will be repaid over the seven-year life of the $195 million debt. Should this happen, the Teton loan includes language that accommodates a springing lien that would allow lenders more concrete security.

The deal, in which ArcLight contributes $100 million in equity, gained a Ba3 rating from Moody's and a B+ rating from S&P. It includes a cash sweep, meaning that the debt has an average life of nearer 3.5 years. Such amortization is not normally a requirement of Term B lenders, but it encourages those with a buy-and-hold mentality to come into the deal. The arranger, while it will attempt to make a market in the loans, issued them at par, and with a margin of 325bp over Libor. The debt has been syndicated, although formal close waits upon gaining the necessary regulatory approvals.

Teton Power Funding

Status: Syndicated February 2004 and set to close once approved

Size: $300.9 million

Location: Several states across the US and Jamaica

Description: Holding company acquisition of 643MW of contracted capacity from Aquila

Sponsor: ArcLight Capital Partners

Debt: $195 million

Arranger: Lehman Brothers

Tenor: Seven years

Margin: 325bp over Libor

Independent engineer: Stone & Webster

Lawyers to the lenders: Simpson Thacher & Bartlett

Lawyers to the borrower: Freshfields Bruckhaus Deringer

Lawyers to Aquila: Blackwell Sanders Peper Martin