# North American Project Bond Deal of the Year 2003

01/03/2004

Calpine's return to financial health has been marked by innovation and daring raids on the Term B and convertible markets every bit as quick and opportunistic as its dealings with higher-grade debt during the power boom. It also placed renewed stress upon contracts, the only instruments against which project finance debt could be raised in 2003. The $375 million Gilroy financing demonstrates Calpine's grasp of these disciplines, and also marks a first for monoline involvement in the sector.

Gilroy, like the SR125 and Path 15 financings (also deals of the year), is the product of the peculiarities of the state of California. It is a portfolio of nine peaking units installed as a direct response to the state's electricity crisis. The 495MW of capacity came online as part of then-governor Gray Davis' emergency siting proposals. Construction on the simple-cycle facilities at the Gilroy site began in May 2001.

The emergency siting proposals, and the fact that the blackouts in the state occurred through a shortage of peaker capacity, led to the state, through the California Department of Water Resources (CDWR), to sign a capacity contract with Calpine Energy Services, Calpine's marketing arm, for 20 years. This deal, signed when power prices were at their peak, included a capacity portion, and a fixed price energy portion.

Calpine and the CDWR renegotiated this, and three further contracts in April 2002 - the final terms called for a yearly fixed capacity payment of $90 million until 2006, and $80 million to 2011. This shortened deal, Calpine estimated, would earn it $800 million over the life of the contract, even though it also introduced gas-price indexing on the energy portion.As such, the financing relies on the same offtake credit as Calpine's Power Contract Financing - the BBB+ rated CDWR (for more details, see Project Finance, July/August 2003). It differs in terms of performance risk - Gilroy, rather than an investment bank's commodities group, is responsible for the contract. It therefore needs coverages closer to the 1.5x level in the base case than the 1.1x possible for asset light deals.

The portfolio consists of 11 LM6000 turbines at various sites throughout California, including the Goose Haven Energy Center and Creed Energy Center, and capacity at the King City and Gilroy baseload plant sites. Those at the site of existing plants need to share common infrastructure - an advantage in terms of speedy installation, but less so in carving out a speedy financing. The peakers even share air permits with the baseload plants - a situation that lawyers that worked on the deal say is unprecedented.The first instinct Calpine had was to look at creating a bank financing for the assets. This inclination will have been driven by the fact that the last Californian financing in the market - InterGen's Wildflower - was a bank deal for a peaker portfolio backed by CDWR contracts. Calpine therefore appointed ING to arrange a financing.

But bank sentiment had decisively shifted since the earlier deal. Few banks were ready to put more money into the sector after the first wave of defaults hit. The issue for potential providers had changed from California to the entire US power sector. It proved to be a difficult deal for ING to make financeable. Deutsche and Bank of America also briefly examined a private placement.

Ultimately it was Goldman Sachs that spotted the opportunity - lingering problems over California, the deal's lead time, and some initial troubles with starting up the units had created a perception of risk, and therefore pricing, that was out of sync with the deal's underlying risk profile, and indeed rating, which was BBB-, according to Standard & Poor's.

This is a situation in which a monoline can add value, making its fee from the diiference between the fair pricing and AAA pricing. Goldman had used a monoline before, on the now-defunct NRG Peaker deal. According to one source close to Calpine, the NRG template 'was mentioned briefly' in the pitch. The key difference with NRG is that, rather than relying on forecasts, the CDWR contract helps make the deal investment grade.But this level would be several notches above the corporate rating for Calpine - currently at B. So the final element in making the deal wrappable is to make the deal as bankruptcy remote as possible - in this case by bringing in third party equity. S&P, in its report on the deal, said that its BBB- rating was conditional upon the close of third party financing. The proceeds of the bonds were to be held in escrow until the deal closed.

CIT Project Finance stepped in to underwrite $74 million in preferred equity, which it in turn syndicated down to unnamed further providers. The preferred equity in some respects resembles sub-debt, in that it gives the providers debt like consent rights and it gets paid before Calpine. This is not the first time Calpine has used the preferred equity structure, although it prefers to keep control of assets wherever possible.

The bonds priced on 1 October, and achieved a coupon of 4%, in line with the AAA wrap from Ambac. They have a maturity of 2011, corresponding with the length of the CDWR contract. With Goldman as sole bookrunner, they sold strongly to accounts from outside the group of power project buyers.

Gilroy contains a number of useful structural innovations - particularly the wrap and the equity investment - but their transferability is hard to gauge. Calpine will use the equity structure if it is looking for clearly-defined assets to get the best pricing possible. Likewise for any sponsor examining using a monoline. However, the monolines do not show any great enthusiasm to enter the independent power sector in a big way. And California-style opportunities will be likely rare.

Gilroy Energy Center

Status: Closed 1 October 2003

Size: $301 million

Description: Financing of 495MW peaker portfolio

Sponsor: Calpine, with additional equity placed by CIT

Bookrunner: Goldman Sachs

Monoline insurer: Ambac

Maturity: 2011

Coupon: 4%

Lawyers to the borrower: Thelen Reid & Priest; Covington & Burling

Lawyers to the underwriter: Latham & Watkins

Lawyers to CIT: Dewey Ballantine

Lawyers to Ambac: Jones Day