First Michigan, then the world

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Kohlberg Kravis Roberts and Trimaran Capital Partners have completed financing with CIBC for the acquisition of the International Transmission Company ? the first stirring of involvement by buyout funds in the transmission business. It also proved popular with commercial banks, several of whom have been looking to sweeten their portfolios with strongly performing paper. Indeed, this growing sector, with its regulated returns, may be the nearest many banks get to the flow from old-style utility contract generation deals.

International Transmission Company (ITC) is the standalone business formed by DTE Energy to hold its high-voltage transmission assets. DTE, the owner of Detroit Edison, formed the company with a view to a sell-off, rather than a securitization. In this goal it has the warm support of the Federal Energy Regulatory Commission (Ferc), which has recently come round to seeing independent operators as the best guarantee of upgrades to, and the reliability of, transmission assets.

The sector has been a prime target for a number of independents, but sales have been slow in the past because of internal difficulties at utilities. Current market sentiment has it that the best placed buyers of transmission (or ?wires') businesses are players with the relevant utility experience or finance houses such as GE Capital or CIT. Trans-Elect, the start-up formed around the core of former CMS executives, and the buyer of Consumers Energy's Transmission assets, has first-mover advantage.

However, financial partners appear to fit the criteria laid down by Ferc almost as well, providing they have access to the relevant skills. The Trimaran team has worked closely with CIBC World Markets (which holds a 40% stake), and its founders are Jay Bloom, Andrew Heyer and Dean Kehler, whose Argosy fund became part of CIBC. While wires deals are not the sole, or even main, focus of Trimaran, it sees a great deal of potential in the sector.

Trimaran was one of the initial bidders on the Consumers Energy assets, and had lined up with Trans-Elect to provide equity for financing vehicle the Michigan Electric Transmission Company. However, in the end, GE Capital stepped up, and CIBC, along with Deutsche, took a lead arranger role. For this set of assets, Trimaran approached KKR, whose muscle and experience in buyouts is unrivalled, to provide part of the equity.

At the centre of a transmission company (TC) credit is the degree of support that it can expect from regulators. Ferc tends to have a substantial, but not exclusive, dealings with buyers, so that relationships with state regulators are of prime importance. Here the fees that a TC can charge to generators and utilities to shift power around a service area provide the bulk of revenues.

The real opportunity for extra cashflow comes from the ability to earn revenue according to value-added services such as relieving grid congestion. Several market players look enviously at the record of National Grid, which has been very successful at selling the UK model and making healthy profits. National Grid, with its telecoms experience behind it, has been looking to expand in the US, but has rarely found an attractive asset. It appears to have become frustrated with the US regulatory patchwork, but may build upon its Niagara Mohawk purchase, if it can find an amenable enough regulator.

In this instance, ITC has already begun the process of negotiation with regulators, and struck an agreement on rates and capital gains taxes with Ferc in late 2000. It has been examining the creation of a creditworthy and viable business for three years, and now carries a rating of A- from Standard & Poor's and Baa1 from Moody's Investors Service. The key, according to Jon Larson at Trimaran, is aligning the interests of owners with the goals of regulators.

According to Larson, ?I believe that equity at stake is the best way to ensure responsible ownership of transmission assets. In my opinion ISOs [Independent Systems operators] do not have the substance to make the assets work.? Larson has said as much in front of regulators, which have warmed in recent years towards taking wires private. Ferc has yet to make a definitive statement, but will probably have looked with suspicion at the activities of some utilities that have used control of transmission assets to curtail independent power generators.

The distribution company involved, in this case Detroit Edison, is still the main credit underpinning the deal. It serves as something approaching an offtaker, although its credit is not simply based on willingness, or even ability to pay. The assumption is that the regulated, monopoly distribution business would not be allowed to fail, or at least the lights would have to stay on. Finding a regulator sympathetic to the existence of an independent wires business, therefore, is crucial.

Such an understanding makes it difficult to raise the highly covenanted project debt, meaning that the new owners decided to look to the Term B market to finance its debt. B debt is expensive, and needs to have security over assets. At 225bp over libor, for debt that is rated A-/Baa1, simplicity comes with its price.

Deciding whether to include further companies within the structure will depend more on in-house management skills at existing companies than financial constraints. At present the company is fairly conservatively geared, at 40%, part of the guidelines laid down by regulators. The company should be in a position to spend more money on network upgrades, providing that it gets a favourable rate increase out of them when this comes up for renegotiation.

This deal breaks down into a $185 million term loan and $15 million revolver at the operating company level and a $240 million holding company loan. The debt apparently went down well with project lenders looking to sweeten their portfolios (a popular side project for banks engaged in restructuring), although it does not have a project finance profile. It decided to replace some mezzanine debt at the holding company level, however, in the face of strong senior lender interest. CIBC's co-leads were SG and Union Bank of California.

International Transmission

Company

Status: Closed March 2003

Location: Michigan, US

Description: Leveraged acquisition financing of transmission assets

Sponsors: Kohlberg Kravis Roberts, Trimaran Capital Partners.

Arranger and advisor: CIBC World Markets

Debt: $300 million

Tenor: 7 years, with minimal amortization

Pricing: 225bp (operating company), 375bp (holding company) over libor

Lawyers to the borrower: Milbank, Tweed, Hadley & McCloy, Simpson Thacher & Bartlett

Market consultant: RW Beck

Tax advisor: PwC