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Two deal wonder?

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The emergence of two large Spanish power projects into European debt syndication marks the culmination of years of work in that market to turn foreign-owned IPP projects from a nice idea to reality. Spain has been at the forefront of electricity market deregulation in Europe, thanks to a combination of benign government policy and urgent need. And this translated very quickly into a burst of interest in developing new capacity in the country.

By mid-2001 the Spanish Economy Ministry had already received applications for a total of 32,740MW of new combined cycle gas turbine (CCGT) capacity to be developed. Spanish grid operator Red Electrica has predicted that 6000MW of new gas-fired capacity will be needed by the end of 2005 and 10,000MW to 13,000MW by the end of 2010. According to Goldman Sachs, 16GW of power plant is set for construction over the next 10 years in Spain.

No surprise, then, that foreign generating companies have seen Spain as perhaps the most exciting new power market in continental Europe, but the actual projects themselves have been an awfully long time coming. This is due to a number of problems, among which have been environmental and licensing hold-ups and the fact that one of the first foreign generators into the market ? Enron ? ran into a few difficulties of its own.

But now two deals stand poised for completion: the ESB-sponsored (via its subsidiary Bilbao Bizkaia Energia) 800MW Amorebieta CCGT power plant and the AES-sponsored 1200MW Cartagena CCGT plant. Turnkey building contracts have been awarded to a consortium of General Electric, Sener and ACS for the ESB-sponsored plant, the winning firms having beaten off competition from Alstom and Mitsubishi for the deal. Debt for the plant is being arranged by Royal Bank of Scotland and is expected to comprise a loan of around Eu600 million over around 15 to 18 years. Cartagena is expected to be looking for more ? around Eu800 million ? in a deal being co-arranged by ABN Amro, SG and Credit Agricole Indosuez.

These are not, however, the first foreign-owned power projects to be proposed in Spain ? just the first to have got this far. US energy generator Enron was already working on a 1200MW gas-fired project in Arcos de la Frontera in the south of the country when it filed for bankruptcy in mid-2001. Enron had been granted government approval for the project in July 2000 and had a commitment from gas grid operator Enagas to build a pipeline link to the facility but construction had stalled due to Enron's financial collapse.

The plant was eventually sold in April last year, together with several turbines and generators in Cadiz, to Iberdrola, which is developing a second 400MW CCGT plant alongside the 1200MW facility together with engineering group Abengoa. Enron also had permits to develop a further two plants in Spain ? an 800MW generator at Tordesillas in the region of Castilla-Leon and another 800MW plant in Catalonia.

And Enron is not the only US generating company to have seen its ambitions in Spain thwarted. US firm Entergy received the green light from Spanish authorities as recently as April last year to build a 800MW CCGT plant at Castelnou in Teruel province. The plant was first proposed in 1999 and was due to go onstream in 2004. Entergy had also applied for the go-ahead to build a 1200MW CCGT at Morata de Tajuna near Madrid. Entergy subsequently sold the rights to both plants in September 2002 to Belgian power firm Electrabel. Electrabel has said that it now expects the Castelnou plant to be operational in late 2005 and Morata de Tajuna in 2006.

Hard sell

The two loans now mandated are being launched into a syndication market that has had a pretty rough ride at the hands of the power sector. The events in the UK market have left many project banks with a nasty taste in their mouths and maybe second thoughts about lending to further power projects. So can these deals get sold successfully? RBS is reported to be planning to underwrite the Amorebieta loan with a view to selldown later in the year but did not return calls by press time to confirm this. In some ways the Cartagena deal will be the tougher sell as it is sponsored by a US power entity ? the image of which has been severely dented by the Enron bankruptcy and financial difficulties across the sector.

?As far as banks' perceptions of sponsors are concerned this may be correct,? agrees Richard Burrett, managing director and global head of project finance at ABN Amro in London. ?The negative perception of US utilities in the market may make the deal a harder sell.? He points out, however, that AES renegotiated its debt just before Christmas to stabilise its finances over the next two years and is now in a much more secure position than it was six months ago.

The company launched the $2.1 billion debt refinancing in October last year. It entailed two bond swaps and a $1.6 billion bank refinancing facility, which will postpone maturities on around $1.85 billion of debt for between one year and 18 months. But the firm has had to put up foreign and domestic assets as collateral for the deal and is incurring higher interest costs (reckoned to be $65 million per year) as a result.

However, John Ellis, partner in the project group at law firm Norton Rose (which is advising AES in Spain), emphasises that the Cartagena deal is a very far cry from the kind of power deals that have run into trouble in the US. ?People need to view this market on a project-by-project basis,? he says. ?These are not the kind of quasi-corporate type structures that were seen in the US.? He thus emphasises that the project structure offers lenders solid protection against AES corporate risk.

Despite its sponsor's financial difficulties, Burrett is bullish on selldown of the Cartagena loan. ?This is a very well-structured project,? he notes, adding that, ?it is attractively priced, has healthy coverage ratios, a robust contractual structure and a contracted income stream extending well beyond the debt tenor.? Burrett will not elaborate further but in can be assumed that the deal may be priced to be markedly more attractive to lenders than the 100bp to 110bp that has been rumoured for the Amorebieta loan. ?There is adequate market appetite for these two deals but [the] AES [sponsored transaction] will be the harder to sell,? observes one project finance executive. ?Lenders are very cautious on US utilities which could be a major hurdle to selldown ? they will need to see a strong financial structure.?

No tolling contract ? no go

In the current climate for power loans, these deals would never have got off the ground without tolling contracts in place. ?Lenders are looking for contracted revenue streams from credible counterparties on power projects given their poor experience with merchant risk,? says Burrett. ?The projects should also have strong underlying economic fundamentals which would position them well in any merchant merit order should the contractual arrangements fall away. Cartagena will be one of the lowest-cost CCGT generators in the Iberian region.? Merchant risk in this market now seems like a distant memory ? and the events in the UK power sector are likely to make sure that it stays that way. ?Tolling is crucial as it exonerates lenders from market risk in a sector where basic profitability over the long term is far from being assured,? explains an executive at a Paris-based French project finance bank. But a tolling agreement in itself is far from a panacea ? what is vital is who that tolling agreement is with. AES itself has learned the hard way the importance of a strong offtaker thanks to AES Drax's tolling contract in the UK with now-bankrupt TXU Europe.

ESB is understood to have arranged a 20-year gas supply deal with Shell for the Amorebieta plant, which is scheduled to go online in late 2004 or early 2005. It is rumoured that the contract could, however, run for a shorter time period than this with lenders taking merchant risk for the difference between the contract and the loan tenor. If so, this merchant tail will be a major consideration for banks looking at the transaction. Cartagena is understood to have an offtake agreement with Gaz de France for the full tenor of the transaction. Both Shell and Gaz de France are solid offtake credits: it should be noted, however, that in the ESB case the offtaker is Shell Espana and whether or not lenders have any recourse to the parent company is unclear.

Recent events, such as AES Drax's difficulties following TXU Europe's default on its tolling commitments, have highlighted just how important the offtake party is in the project structure. ?First class uptakers are crucial for any deal to get done,? notes one project finance executive. So could it now be the case that lenders will look more closely at the offtaker than the sponsor on power deals and the quality of the tolling counterparty be the most important factor in any deal? ?Where the offtaker is taking the commercial risk of the project, maybe as both supplier and offtaker, then this is a fair comment,? says Ellis at Norton Rose.

Gas distribution still a problem

Despite the advent of these two syndications, there are still some significant problems to be addressed in the Spanish power market in order for the flow of future deals to be assured. Perhaps the most significant of these is that of gas distribution. ?Transportation infrastructure is a huge problem,? explains the Paris-based banker. ?In some regions there are huge constraints on gas capacity ? in some areas there is simply no gas capacity available.?

Spain's long-distance natural gas network is made up of 5,970 km of pipeline which is owned by Enagas. Enagas itself was 100% owned by Gas Natural until June last year when the latter was forced to reduce its holding to 35% via an IPO. The Spanish government is aware of the problems facing gas distribution in the country and Enagas has therefore earmarked Eu1 billion for investment over the next 10 years ? 80% of which will go on transportation and regasification projects. This will need to happen for the pace of planned power plant investment to be maintained. ?Spain has historically been gas constrained and there is a need for a reinforcement of the current infrastructure,? notes Burrett. ? Siting of power plants is therefore critical ? you must have a well-sited project. Cartagena is 500 metres from its LNG import terminal.?

While the successful syndication of these two power plants will give a huge fillip to the Spanish IPP market, this sector has still to experience the level of activity that has been seen in another area of Spanish power generation: wind farms.

Current installed wind power-generated capacity is 4,100MW but Spain aims to increase this to 8,900MW by 2010. Spurred on by generous tax incentives there has been a flurry of activity in wind farm financing but the majority of this has ? due to the nature and size of these projects ? been made up of small deals financed by domestic players.

There have, however, also been some sizeable deals signed. For example, in October last year HVB Group arranged the Eu213 million Eurovento loan for Iberdrola to refinance six wind farms. Output from the facilities is contracted to a number of offtakers including Union Fenosa. The facility was split into a 180 million 15-year term loan and a Eu32 million two-year VAT facility. There was also a 15-year letter of credit facility of Eu1 billion. Iberdrola is consolidating its position in the wind farm market with an agreement to purchase more that Eu1 billion worth of wind farm assets from Gamesa Corporacion Tecnologica (the leading wind power producer in the country) by 2006. This sector has attracted keen interest from abroad, with GE Wind energy paying $380 million for the Spanish assets of Enron Wind Corp in December last year. GE has a 12% stake in Spain's wind farm market, with 255 generators installed, but plans to increase its market share to 16% by the end of this year.

One of the driving forces behind this market is the generous subsidy package on offer for the development of renewable energy sources in Spain. But there is now draft legislation due to come into effect in 2003 that proposes to cut the level of subsidy available. If this draft legislation becomes law it will clearly have the likely effect of putting the brakes on this booming sector of Spain's power generating market.