Credit crisis

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?Market conditions' has become a polite way of describing the corporate credit crunch facing America's structured finance users. But it is precisely such conditions that have recently led to a sudden lull in structured and project financings by many highly leveraged energy corporates. The Enron collapse needs little introduction. But the sharp refocusing of credit rating analysis, on the other hand, does ? particularly when it is altering the way many developers approach their balance sheets.

Widespread change has been mooted in the energy industry. As Bill Chew, managing director of project and infrastructure finance ratings at Standard & Poor's (S&P), puts it, ?last year marked a real turning point, but much hinged on a shift in perception, rather than a material change of events.? And from the point of view of credit analysis, he adds, ?the basic analytical framework, though it has been expanded somewhat, has essentially remained unchanged ? that is, standard, bottom-up analysis.?

Closer examination of balance sheets and accounting practices is, of course, being felt throughout the corporate world, with greater scrutiny of the special purpose vehicles (SPVs) used to set up off balance sheet transactions, particularly in the energy sector. But in theory, the agencies' analytical approach to specific off balance sheet instruments is the same as before: ?I'll say emphatically that we haven't changed our view on this,? says Chew. Vigilance, however, is now more intense than ever.

Attempts to stay ahead of the ratings agencies abound. Indeed, in a concerted effort to defend itself, the entire industry is calling for greater transparency. But, say the agencies, transparency is not enough ? energy players must still improve their liquidity and cashflow. Accordingly, there has been heightened attention to contingent liquidity, collateral and other performance criteria at the likes of Williams, Mirant, AES and Calpine ? to name a few.

In a recent report, S&P unambiguously points out one of its key concerns: ?a strong vulnerability to rating triggers, if not remedied by the issuer in the meantime, could be one of the factors in any future downgrade.? Agencies are now scrambling to identify corporate exposure to contingent calls in liquidity.

But this is not a new idea. In fact, says S&P, it began its investigation into ratings triggers early last year, in response to changing market conditions and partly spurred by the California power debacle.

Compounding the current sense of urgency, however, are new proposals on accounting for off balance sheet vehicles, to be published by the Financial Accounting Standards Board (FASB) in April. The proposals may well affect project sponsors that have legitimately used previously commonplace SPVs to lower their cost of borrowing.

It is possible, then, that non-recourse liabilities could be added to consolidated balance sheets if the board's rules are changed. The extent to which an accounting change could impact debt ratios and covenants on project and structured finance deals has yet to be seen.

But both Moody's and S&P have stressed throughout that they already account for such deals on the corporate credit rating. That is, if an asset is core to a corporate business, it will have figured in the corporate analysis, even if it is technically non-recourse. Whether a project is thus construed as an ?on credit? transaction is, of course, a key part of what the rating agencies do for energy companies. And, according to Susan Abbot, head of project finance ratings at Moody's Investor Services, ?this is one of the more difficult questions we are faced with.?

But the degree to which the agencies actually account for such deals in corporate analysis is also a key question. Suggests a London based project banker, ?the relationship between project rating analysis and corporate credit analysis hasn't been as thorough as it should have been.? This, arguably, is changing, with possibly more sophistication and sensitivity being brought to an expanding analytical framework.

Contingencies, vulnerabilities

Credit ratings represent a judgment about the probability of default, but some situations face more threatening consequences (indeed, default) if certain risk scenarios unfold. S&P refers to this aspect of ratings as the ?credit cliff?, a dynamic which played itself out dramatically in the case of Enron and the California utilities.

Rating triggers were devised to protect creditors. And, in many instances, they have.

But, says, S&P, they can also ?precipitate a liquidity crisis ? and even default ? as the result of just a single notch downgrade.? Enron was a prime example of a company with ratings triggers in both its trading contracts and its off balance sheet financings. The triggers set off its death spiral; though they did not cause it, they accelerated it.

The underlying question is how the actual liability relating to rating triggers is reflected all along in a company's ratings. Says S&P in a recent release, ?ironically it is not typically a rating determinant, given the circularity issues that would be posed. To lower a rating because we might lower it makes little sense ? especially if that action might trip the trigger.?

True enough. But the agency is now proposing a wholesale review of rating triggers and other liabilities. It has been conducting surveys, initiated at the beginning of the year, of all investment grade rated corporates, to pinpoint those that might contain contingent obligations with a probability of affecting liquidity (either through acceleration, redemption, termination, exchange or posting of collateral).

?We have a systematic set of questions we're putting to the corporates. But rating triggers are just one aspect. We have to look at covenants as well. Financial flexibility is now a more complex discussion,? says Chew. No situation has been identified yet in this review as warranting a rating change.

Ratings provide the market with an opinion of creditworthiness independent of market price behaviour or prevailing market sentiment. At the same time, there has been some criticism of agencies for having perhaps placed too much emphasis on market concerns. To this, Moody's has responded, ?it is possible to be aware of market opinion without allowing it to substitute for fundamental credit analysis. Market opinion is typically extraneous except when an issuer's loss of marker access has near-term liquidity implications.?

Says Abbott, ?we released a statement recently suggesting that we might be looking to review our analytical criteria. The reality, according to the feedback we've received from our clients, is that our ratings have worked for 100 years so let's not change anything.?

According to Chew, ?the real challenge now is to look at individual companies. Some of these credits, like AES and Calpine, we've highlighted as being real risks which are unlikely to reach investment grade. But we need to get back to the world of basic analysis, to reassert fundamentals like debt structure, contingent debt exposures, covenants and overall headroom.?

Ultimately, what will determine the impact of non-recourse deals on the corporate credit will be, in Chew's words, ? whether or not they are likely to be supported by real and ongoing economic incentives.?

But issues linger for many developers. ?We can't do projects and build businesses if we don't understand the mechanisms by which they'll be evaluated. For instance, will ratings include market pricing input; will they be based on bottom up cashflow analysis; will they take into account history or deliverability?? asks one US power developer. ?Right now the methodological handbook to be used by the agencies is not fully clear to any of us.?

Untrusted shares

Chew points to the limits of financial engineering. ?Complex risk transfer will still result in the same bottom-up evaluation of credit.? he says.

But, one consequence of the Enron calamity has been its effect on structured deals. Says one US power developer, ?any special purpose vehicle that has a relatively complicated risk transfer mechanism will be affected by current sensitivities and is therefore unlikely to be pursued.?

One such structure to have been hit hard is the share trust. In all, around 10 of these deals have been done, totaling some $10 billion. ?In terms of the mechanism, a share trust structure has become a discredited credit enhancement,? says Tom Kilgore, vice-president for structured finance at El Paso. But the agencies' concern is with the structure's built in rating trigger mechanism, not its use as a credit enhancement tool, he points out.

El Paso completed a $950 million bond issue for an off balance sheet affiliate backed by shares held in trust, the Gemstone Investor trust. The deal, led by CSFB, marked the first time the off balance sheet vehicle had been used to fund project construction overseas.

The share trust was set up to fund El Paso's continued development activity in the Brazilian power market, and was essentially a construction vehicle designed to provide flexibility and off balance sheet treatment while avoiding some of the restrictions imposed by a construction agency agreement.

The vehicle's creditworthiness was supported first by the proceeds from any project level borrowings, then by the issuance of El Paso equity and finally by the existence of mandatory convertible preferred stock held in the wholly owned share trust.

The highly structured transaction weathered the initial storm. Like a similar vehicle structured by Williams, it has subsequently been unwound, largely because of the possible Enron taint: ?It wasn't the transactions that failed,? insists Kilgore. ?the structure is dead because of Enron's underlying rot.?

Share trusts are done off balance sheet though they are essentially full recourse. The problem, according to a banker familiar with the vehicle, is that the rating agencies viewed them as subordinated debt. Because the issuer has the obligation to issue equity, agencies gave the deals anywhere from neutral to equity-like credit.

For El Paso, in this case, the risk is the contingent liability. The ratings trigger, at Baa3, was very close to the corporate rating and so the likelihood of a breach was very high, particularly given market sensitivities.

Says the banker, ?although they were rated as sub-debt the agencies in their own analysis said it was neutral and no one took into account what the effect of a downward spiral on stock would be.?

He adds, ?they had a somewhat Pollyanna-like view of what these securities were. Though the vehicles were rated correctly, it was the effect of the share trust on the parent itself that was not analyzed correctly.? By having doing done a few of these deals, the banker implies, the agencies ought to have reconsidered the corporate ratings.

Abbott suggests market reality has since shifted assumptions. ?The assumption before was the you'd never get a share price drop and a downgrade at the same time ? our opinion is rather different.? In the end, however, the issuer was unable to parcel out the deal's contingent liabilities and the structure did affect El Paso's corporate credit analysis.

Refining the trigger

The deterioration in credit quality of many issuers has narrowed the gap between such rating categories and the actual credit rating of the issuer. And where the gap between the current rating and the trigger level is less than one full level, this type of clause has more negative implications for the corporate risk profile.

The results of the agencies' current review of contingent liabilities have yet to be assessed. But S&P suggests that some companies ?will want to address their high level of perceived risk by endeavouring to remove the troubling provisions from their financial agreements.? As El Paso illustrates, some are already doing this. To this end, the agency continues, their chances for success are bolstered, ?by growing recognition on the part of lenders and other counterparties that triggers can backfire.?

?Now, Standard & Poor's is considering a more active posture, one that encourages companies that have triggers to remove them or perhaps face a downgrade.?

But if triggers are to be dissolved, then what will take their place, particularly when it comes to shielding lenders from a deteriorating credit? ?Replacing a trigger with a financial benchmark of similar consequence accomplishes nothing,? states S&P.

The issue is far from resolved ? indeed, it is only now that it has taken on an added urgency. Finding ways to make the risks more transparent, then, will become the central focus of a combined effort.

Notes one US power sponsor, ?the financial lending community has become addicted to triggers in their various forms as early indicators of problems.? But if triggers are deemed to be generally unacceptable in their current guise, then ?the whole financial industry will need to wean itself from this addiction? while finding new ways of undertaking surveillance and due diligence. ?It's as if someone has just informed a heavy addict, the lending community, that its about to get cut off,? he adds.

But a common market standard, notes one industry banker, is something that will ?create itself,? though probably at the behest of the more heavyweight lenders.

Restructuring

Many US utilities, having been hit hard by steep credit quality decline after California and Enron, are setting about strengthening their balance sheets, partly to win back credit rating agencies' affections.

El Paso, for one, is attempting to shore up its balance sheet and enhance its cash flow with equity offerings, asset sales, and reduced capital spending. It has ?recognized? the need to maintain lower debt balances, reduce liabilities, simplify its capital structure and address uncertainties surrounding its rating triggers. In response, it has gained plaudits from S&P, who described its actions as being ?prudent steps that may be duplicated by other firms engaged in the merchant energy business, and ultimately viewed as necessary steps to secure creditworthiness in the market.?

One of the lessons learned from all this is, according to Abbot, that ?companies have to think very hard about whether it is appropriate to finance core assets in a non-recourse way.?

AES is one of those companies. Though a credit crisis is not anticipated by the agencies, a substantial decrease in cash flow distributions from its many subsidiaries, coupled with the current capital market environment, might yet pressure the parent ratings even further. There are no known rating triggers that would result in either cash calls on outstanding debt or an immediate liquidity crisis. The corporation, however, recently unveiled an ambitious plan to restructure its business, speed up asset sales and boost its creditworthiness. Others, like Calpine and Mirant, are following suit.

And the credit analysts will be watching carefully, while their respective agencies strive to carry out two simultaneous and daunting tasks: ?conscientious introspection,? as Kilgore puts it, and a mass reevaluation of areas previously overlooked. But, he adds, ?despite the immense challenge the agencies are facing, they are by and large meeting their goals, and ours.?