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El Paso has found its recent structured finance activity severely curtailed by Enron. It is not alone in being the victim of changing investor sentiment. Calpine is another prominent victim. Its share price, along with other merchant energy producers, has taken a hammering. Most energy executives argue to little avail that no-one else had as deserted an asset portfolio as Enron. Credit rating agencies want to see more evidence of assets or cash backing trading operations ? power stations should not all be supported by structurally subordinated debt.

This new approach has had immediate effects on the way energy players treat their balance sheets. Dynegy has announced a plan to raise $500 million in equity at a time when it would really rather wait for its share price to recover. It has also promised to sell off the recently-acquired BG Gas Storage business, a potential setback to its plans for dominance of the European energy trading market. Likewise Shell, which has sold InterGen's Tejas Gas business to Kinder Morgan for $750 million, around half the value that it fetched when acquired three years ago.

Mirant has been one of the more quickly penalised merchant players. It has confirmed that, aside from three lease transactions (including 2000's sale leaseback on its PEPCO acquisition), it has little in the way of off balance-sheet debt, project financings aside. Nevertheless, Moody's Investors Service has unceremoniously dumped it from the investment grade category, although there are no ratings triggers affected by this move.

And El Paso has been probably the hardest hit by the changes, partly because it is an influential merchant energy player, but also because it was one of the more open users of off balance sheet structures. It has carried out Project Electron to monetise some hard assets and this year carried out a contract monetisation for swaps associated with a Niagara Mowhawk PPA in a $175 million private placement led by CSFB. The deal has echoes of Enron's approach to booking forward earnings, although El Paso has been more open in how it treats such transactions.

But the clamour for a simpler balance sheet has been overwhelming, and El Paso has not been immune. It has been forced to announce the disposal of $2.25 billion in assets and reduce capital spending to $3.1 billion. The coming months will see, as with Dynegy, a fresh equity issue. And the off-balance sheet financing vehicles are probably on the way out.

El Paso completed a $950 million bond issue for an off-balance sheet affiliate backed by shares held in trust. The deal, led by Credit Suisse First Boston, is an unprecedented use of an off balance sheet vehicle to fund project construction overseas. El Paso has created a similar vehicle for some of its assets, and gained plaudits from the finance community for its ingenuity. But so did Enron.

The shadow cast by the Enron debacle will probably affect structured deals permanently ? one prominent project financier has already proclaimed the death of complexity in infrastructure finance. More importantly it created some of the nastiest conditions imaginable for a structured bond issue. That it could have created an extremely useful tool for emerging market project investments is easy to overlook.

The proper background to the creation of the Gemstone Investor Trust (and Gemstone Investor Limited) is El Paso's continuing development activity in the Brazilian power market. El Paso remains very confident about the potential for generation projects in the country, tariff and gas supply issues notwithstanding. At least part of this confidence stems from the fact that El Paso is not involved in the distribution business and therefore does not have to make both ends of the emerging deregulated electricity market work economically.

Gemstone Investor was described by Tom Kilgore, vice-president for structured finance at El Paso as ?a vehicle we established to capitalise a business we would like to grow over the next three years?. The vehicle is, essentially, a construction vehicle designed to provide flexibility and off-balance sheet treatment, but avoid some of the restrictions imposed by a construction agency agreement.

There are five plants designated for Gemstone, a mixture of those operating and under construction. The first two ? Manaus and the $116.5 million, 158 MW Rio Negro ? went into operation between March 1998 and September 1999 and were constructed on the sponsor balance sheet. The third is the Termo Norte project located near Porto Velho, whose first phase went into operation in September 2000 and whose larger second phase is under construction. The fourth is Araucaria ? perhaps the most high profile since it this joint venture with COPEL and Petrobras is looking for non-recourse funding with the participation of US Exim. The final project ? Macae ? featured a turbine warehouse and construction agency agreement from WestLB.

Some observers of the transaction have suggested that the Gemstone deal is a way to provide El Paso with a funding cushion whilst international lenders become comfortable enough with Brazilian risk to provide a long-term debt package to the projects. This argument makes less sense when the sums advanced by El Paso and its structured lenders ? which largely cover construction ? are taken into account. And Kilgore is emphatic that the structure is not a quick fix. ?We view the Brazilian market as a location for a growing business and believe that it has regulatory and political risks that can be encountered in many other places, including in the US.? The point is well-made ? El Paso's pipeline division is locked into a dispute with the California Public Utilities Commission over gas capacity contracts during the state's energy crisis.

However, despite the ongoing energy crisis, and concerns about the operation of the spot market, where trading accounts have been suspended, the plants are performing well. Indeed, Enron and El Paso, as early merchant entrants, have been successful in exploiting Brazil's tight supply situation. Cashflows from these plants were designed to be the principal sources of repayments for the note issue.

El Paso did not decide to attempt to put together a construction finance revolver or portfolio facility, both of which would have been equally groundbreaking, but fraught with difficulties with regard to assuaging lender concerns. ?We looked at the cost-benefit for all of the potential structures and did not find the others to be supportive enough', says Kilgore.

Gemstone's creditworthiness was supported, however, first by the proceeds from any project level borrowings (Araucaria appears to be the principal candidate here), then by the issuance of El Paso equity, and finally by the existence of mandatory convertible preferred stock held in a wholly-owned share trust. These shares are to be issued under certain pre-defined events, and would result in a dilution of the parent company's equity. It is this last which has the clearest similarities with Enron deals, insofar as one of Enron's deals, LJM2, triggered a share issuance after running up losses.

Gemstone differed from other such vehicles in that its overfund account, designed to cover interest and yield, was funded for one year rather than the life of the notes. El Paso issued sufficient shares to the trust to cover twice the shares required to pay off the principal, based on El Paso's share price at closing, or enough to withstand a 50% price drop. The trust was to be augmented by further shares as and when falls in the price would require a remedy.

El Paso had to work hard to avoid the fall-out from the Enron revelations, but some difficulties were unavoidable. The deal was to have come with a Euro tranche, but this was pulled two days into the European roadshow. Orders were looking reasonably strong, but investors could not be assured of reasonable liquidity for the notes since European investors remain easily disquieted by bad news from the US energy sector.

Another area where the transaction was hit was in the pricing. An essentially corporate credit ? rated Baa3 by Moody's Investors Service and BBB- by Standard & Poor's ? came in with a 7.71% coupon. Kilgore admitted that the pricing was a little wide, but added ?we were facing a market that had severe turbulence from war, anthrax, the threat of recession, and on top of that the Enron situation. I'd say that's a pretty strong headwind to deal with, but we got a lot of orders.?

Moreover, El Paso has a record of openness about, and investor base for Limestone Electron, that it had used to leverage US assets.

Investors' questions centred on the robustness of the structure, but the wider analyst community wanted to look more at the viability of the businesses. The reason for this is that whilst the vehicle at present remained off balance sheet, and enjoyed healthy tax benefits, default events would impact relatively severely the corporate balance sheet. El Paso hopes that a standard of disclosure higher than its competitors can assuage many of these doubts, and is fully prepared to discuss the fundamentals of its business. Nevertheless the ratings agencies consider the notes on credit, with S&P highlighting concerns about the risks inherent in a Brazilian merchant strategy. In the end the issuer was not able to defer or stagger the possible liabilities from the deal and the deal affected El Paso corporate credit analysis. In light of the unpleasant surprises sprung on investors in the Enron debacle, such conservatism is probably understandable.

Nevertheless, El Paso still went ahead with another PPA monetisation ? Cedar Brakes II. The first Cedar Brakes (for analysis see Project Finance October 2000) involved the securitization of a power purchase agreement with PSE&G, the New Jersey-based utility. This transaction, therefore, involved a hard asset (a PPA is close to an unconditional obligation), but transferred performance risk (as opposed to offtake risk) to El Paso's trading arm, which was free to source the power from anywhere within or without of its portfolio. In return for loosening the obligation PSE&G renegotiated a lower-priced PPA.

Cedar Brakes II involves another set contracts ? again with PSE&G ? from El Paso's East Coast Power plants. There are three plants in East Coast Power, which are covered by four PPAs, of which two are with PSE&G and a further two with Jersey central Power & Light and with ConEdison. The features that distinguish this deal from the first are that East Coast Power is publicly rated as a genco bond issue and that the benefits from the renegotiation of the PPA are handed to PSE&G upfront, rather than staggered or included in the new tariff.

Cedar Brakes buys out two contracts, due 2008 and 2013, and as the intermediary between El Paso's energy trading arm and the utility. Fixed capacity payments service the debt on the $431.4 million issue. This priced on 7 December, with CSFB again acting as bookrunner, and came in with a coupon of 9.725%. The notes are due 2013. The deal was meant to be in the region of $540 million, but came in substantially lower, partly through investor concerns, but also because the issue carried a spread of 500 basis points over treasuries. Moody's rates the bonds at Baa2, S&P at BBB, and Fitch at BBB.

The main credit concerns are the possibility that El Paso would be unable to perform its supply obligations (remote even in the current climate), or that PSE&G repudiates the contract, which is also unlikely given the current attitude of New Jersey reglators and as long as power prices stay above reasonable levels. The last unknown is the ownership structure of the Limestone Electron trust. This is a co-owner of Cedar Brakes, for accounting purposes, and its future relationship with the El Paso balance sheet is uncertain. Restructuring may spur further retrenchments from El Paso's cutting-edge structured finance paradigm.