Northeast Gen: pumping the market

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Northeast Utilities (NU) has closed a $430 million bond financing to take off balance-sheet its new unregulated generation assets. The assets are predominantly hydroelectric and the portfolio's centrepiece is a pumped storage station, so the bookrunners are presenting the deal as a first for a pumped storage facility. For the purposes of Northeast Utilities, however, the financing presents it with a core vehicle for expanding, whether by acquisition or development, its unregulated generation business.

The name of the special purpose vehicle is the same as that given by NRG Energy to its assets in the region ? no coincidence since both gencos were formerly owned by the same utility. NU began the process of deregulation in 1999 with the sale of its generation capacity through a JP Morgan-led auction. NRG picked up the fossil assets (and launched them into the bond market in the early part of 2000), whilst NU set up an acquisition vehicle, Northeast Generation (NG) to make a pitch for the hydro capacity.

In April 1999 Citibank/Salomon Smith Barney picked up the financial advisor's mandate, and the auction took place over June and July of that year. Regulators in the region, which oversaw NU subsidiaries and sellers Connecticut Light & Power and Western Massachusetts Electric Company, were apparently happy with NU bidding, although the sponsor insists that rigorous Chinese walls were in place.

At the close of the sale in March 2000 Citi extended a $430 million bridge loan to the sponsor, which was syndicated to a club of seven banks, as well as an equity bridge of $463 million. At the time the assumptions made by the sponsor were more conservative than the eventual structure that emerged. Whilst the deal was not highly leveraged, how the assets would fit in with NU's merchant strategy had not been finalised.

This is much clearer now, with the plants, maintenance personnel and the offtaker all within the NU Enterprises group. The offtaker, known as Select Energy, was formed in 1997 to operate in the deregulated wholesale market, and its obligations are guaranteed by NU. Select bid for the supply contracts for Connecticut Power & Light, and has won these. The intention for NU will be to extend the PPA between Select and Northeast Generation, but this probably depends on Select remaining as a player within the old utility's footprint.

Ratings agencies and the banks have assumed, however, for the purposes of the financing, that the plant will be operating in a merchant environment after 2005, the agreement's expiration year. The bonds have been issued in two series, with a short piece of four years reflecting the PPA and a longer piece, of $320 million, carrying merchant risk. It is in attempting to discern how a predominantly hydroelectric portfolio will perform in that environment which presented the greatest challenge to the analysts and assorted advisors on the issue.

Northfield Mountain, representing 1080MW of the genco's 1268MW capacity, is by far the most important asset. It is a pumped storage facility, which uses water pumped uphill during off-peak periods to capture value from short-term, and on-peak price spikes. One advantage in financing such a facility is that it eliminates a great deal of hydrological risk, since the plant can theoretically operate as a closed loop using the same water. In practice the plant is linked up with the Connecticut River system, where several other dams within the portfolio are located and under Northeast Generation's control.

The difficulty in financing such a plant is that credit analysis depends on price predictions that need to be adjusted hour-by-hour. Revenues are dependent on the spread between peak and off-peak prices, which are themselves a reflection of demand patterns, fuel costs, and reserve margins. Broadly speaking, the market analysts (PA Consulting) assumed an average annual growth rate in demand in NEPOOL of 1.94%, stable prices and a reserve margin of around 15%.

However, indications are that the New England ISO might consider incentives to entice new flexible capacity into the market. This would take the form of ?quick-start? payments to generators, and would benefit NG greatly. The sponsor was inclined to include these revenues in the base case, although some ratings agencies, notably Fitch, disagreed. Such a distinction is important, since under the best scenarios it could represent the difference between debt service coverages in the 2.2 to 2.75 times range (without quick-start) and those in the 2.7 to 3.7 times range. The additional charge is part of a proposal put to Ferc, and the final incentive package is uncertain.

The other major concern for investors is the covenant structure attached to the issue. This is not a closed-ended portfolio tied up along classical project finance lines, but the germ of an unregulated business. Therefore, the genco's indentures allow additional debt at the portfolio level subject to maintenance of its rating. Mergers and disposals, as well as the ability to incur purchase money obligations, are also permitted. Even with strong regional reserve margins going forward, NU will be eyeing both its peers' and jaded independent power producers' assets carefully.

The bonds were another, minor, casualty of the September 11 attacks, which stalled production of the offering documents. In the end, NG was one of the first structured issues to emerge in the aftermath, and came out with a rating of BBB- (Fitch), Baa2 (Moody's) and BBB- (Standard & Poor's). Competing issuers suggested that the bookrunners were forced to price wider than they had anticipated and this had an effect on other issues. On October 11, the bonds came out with a coupon of 8.812% for the long series and 4.998% for the short piece. According to sources at the bookrunners, the ongoing dispute over a failed merger with Consolidated Edison, did not affect the sell-down.

Northeast has suggested that it is actively looking to buy new plants, and recently acquired Niagara Mohawk's marketing operation. It may not look at a similar financing arrangements, since pumped storage facilities are rather rare, but may find that further financing at the NG level is an attractive possibility.