IJGlobal
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The next wave

01/10/2001

No one could have guessed what 2001, the first year of the new millennium, held in store for the merchant power business. It began with an industry that had previously been taken for granted by most Americans. For years, there had been low cost, abundant power supplies becoming even cheaper due to competition and deregulation.

Boom times

Suddenly, the power generation business was making front page headline news in USA Today, with stories covering power shortages in the California market. Deregulation was to blame, and ?out of state? power producers were pilloried for profiteering at the expense of the public. The State of California jumped into the utility business, raising electricity rates and funding billions in cash shortfalls, but not until after the once-mighty Pacific Gas and Electric and Southern California Edison were bankrupt, and hanging on for dear life, respectively.

Merchant power producers outperformed the ?spark spread? projections in every independent consultant's pro forma forecast from every merchant power project financing. All of those complex, interactive price duration curve hourly dispatch models were no match for an unexpectedly low rainfall in the Pacific Northwest, a gas pipeline accident in the Southwest, and a State that turned ?Nimby? (Not In My Back Yard) into ?Banana? (Build Absolutely Nothing Anywhere Near Anything).

Several merchant power companies, including Southern Energy (Mirant), Reliant Energy, NRG, and Orion Power, took advantage of the bull market to issue Initial Public Offerings, which generally fared very well. Several others have IPOs in the wings. Spinning off equities replaced the generating asset sales of the 1998-2000 period as the preferred method of putting distance between regulated utilities and the unregulated generators. Several asset sales scheduled for 2001, including Nevada Power, were cancelled due to regulatory concerns over whether there was enough capacity in the market to assure competition and low prices. Or perhaps they were just concerned about the politics of deregulation in the face of so much bad press in California.

New gas fired merchant plant construction, which began in earnest in 1998, began to come on line in 2001, creating endless photo opportunities for politicians whose new found policies to stimulate power plant construction had miraculously borne fruit. No company matched the performance of Calpine, which expects to place a record 5,600 MW in 13 new facilities in service in 2001, with many more to follow in 2002. While Calpine is widely acknowledged to have the ?first mover advantage,? many other producers have had banner years completing new plants in 2001, with a growing pipeline of projects due to be completed over the 2002-2004 time frame.

With forecasts of weeks on end of rolling blackouts and sky high power prices in the hot California summer, it seemed like perfect timing for power producers. Power producers were locking in long term contracts at attractive rates, and there was a mad scramble to install peaking units, rail car mounted mobile generating units, micro turbines, and just about anything that could induce an electrical current in time to cash in.

Power bust

Then, just as the consultants adjusted their forecasts for the ?high gas cost? scenario and public authorities had decided who would be exempt from the rolling blackouts and what emergency plans would be enacted at each escalating stage of power shortage alert (not just in California, but in other states, like New York), the market moved again. Mild weather, reduced economic activity following the bursting of the internet bubble, and the supply side response in natural gas and power generation conspired to bring power prices back down to earth.

Suddenly, in August, the financial press began publishing articles on the ?coming glut in power generating capacity?. Who knew that so many people read Barron's? Common stock prices for merchant power generators plummeted, in many cases by as much as 50%. In recent weeks, power generators have quietly begun announcing a trickle of new plant cancellations.

It seems impossible, but over the course of six months, the market has gone from shortage to surplus, even though it typically takes 3-4 years (or longer) to plan, develop, finance, build and complete a new gas fired power project. With such long lead times on the supply side, and such unexpectedly short market windows of demand, how is it possible to plan the development, construction and financing of new projects?

Short term financing

In earlier years, there was a balance of sources of financing for new power plant construction. Even in the boom and bust cycle of 2001, there is still a base level of cash flow that new power plants will produce that allows for substantial amounts of debt financing. Typically, debt financing has been balanced between short and intermediate term bank financing, private placements, 144a bonds, and structured financings, such as synthetic and tax oriented leveraged leases. In early 2001, the California crisis made the long-term debt markets less hospitable. At the same time, many merchant power generating companies were able to adopt a financing strategy based on borrowing large amounts of money from the bank market based on a pool of generating assets as collateral.

The gas fired power plant construction boom was already well underway when the aforementioned California energy crisis first developed. The bank market was able to absorb increasing amounts of commitments, in part because the merchant power generators had invested substantial amounts of equity in new plant construction, and because other ? hot? lending areas within the banks, such as technology and telecommunications, had already slowed considerably. However, as the year wore on and volume increased, spreads began to widen, banks exercised ?market flex? provisions in their underwriting commitments, and deals took longer to complete syndication. We do not have complete information, but the number commonly bandied about the market is $20 billion of bank construction financing for the merchant power generators. Refinancing these loans will pose significant challenges to the merchant power generators companies, particularly if the common equity market remains weak or spark spreads are low at the time of the refinancing.

A typical bank facility includes a revolving credit during construction, and a term loan during operations. The term loan typically matures in a large balloon (for amortizing term loans) or bullet (for non-amortizing loans), 5 to 7 years from the initial closing. No doubt there will be many more market surprises before these facilities mature and need to be refinanced. Market conditions will determine which alternative is most attractive at the time, but what follows is a brief discussion of a non-exclusive list of possibilities:

Refinancing alternatives

New Bank Borrowings

The banks may become accustomed to having the loans outstanding on their books, and seek to find new ways to

generate additional fee income, while retaining the interest income. The more creative short term alternatives include commercial paper conduits, which have the dual advantage to the banks of creating more paper for their money desks to place, while generating off balance sheet fees for credit support facilities. They may also have funding cost advantages to the issuer.

Synthetic leases are also common in the bank market. Many turbine warehouse financing and plant construction financing vehicles have actually been established as off balance sheet synthetic leases. A synthetic lease is off balance sheet to the generating company for accounting purposes, while the asset is treated as being owned by the generating company for tax depreciation and amortization purposes. The transaction typically has three tranches. The first is amortized over its life through rental payments the generating company lessee is obligated to make. The provider of the second tranche has the asset, which is significantly de-leveraged after the generating company lessee repays the first tranche. The third tranche is essentially the equity in the lease, and looks to the asset after the second tranche is repaid. In general, bank lenders are quite comfortable that the generating company lessee will buy out all three tranches, rather than pay off the first tranche and allow the second and third tranche lenders to take the plant.

144a market bonds

The bond market has become an increasingly successful market for long term financings of power projects, since the Sithe Independence Project almost a decade ago. Spreads widened out when the California power problems first occurred. With the dearth of bond issuance that followed, spreads have come in steadily throughout the year. Performance of the industry has generally been quite solid, from a credit perspective, but the market tends to be led by institutional investors with a long history of investing in the power industry. Bond funds and other broader debt market participants have not been as active in this market, leading to occasional liquidity issues, as has been the case in the fourth quarter of each of the last three years. Credit companies, such as Tyco Capital (formerly CIT) are developing innovative ways of participating in this market, thereby providing additional liquidity to generating company issuers.

Private Placements

The volume of privately placed long term power project senior secured financing has declined in recent years, relative to the volume of transactions in the 144a market. However, many institutional investors (principally life insurance companies) maintain significant investment expertise in the power sector and have substantial appetite for private investments. Private transactions are well suited for issues in the $25 ? 200 million range. They also fit well with single asset project financings, or other highly structured transactions where investor sophistication, speed of execution, preservation of confidentiality, and/or the need for firm commitments are at issue. Private placements can also be executed in combination with a long term amortizing bank loan, which potentially offers cost savings and the capacity for a larger transaction.

Term synthetic leases

Private institutional lenders can also provide synthetic lease financings, which are off balance sheet for accounting purposes, while tax ownership remains with the generating company lessee. The attraction relative to the bank market is the longer tenor available in the institutional market, thereby reducing refinancing risk and locking in attractive long term rates for the term of the financing. The longer term raises some issues regarding the unguaranteed portion of the transaction and the residual exposure of the lender to the long term value of the asset. This issue may be overcome with a residual value guarantee provided by either an insurance company or a financial guarantor. Credit companies, such as Tyco Capital (formerly CIT) often provide the equity for these transactions.

Tax oriented leveraged leases

Most of the tax oriented leveraged leases have not been driven by tax motivations. Typically, generating facilities are

depreciated for tax purposes over a 15-20 year period, which is relatively long. Getting the financing off balance sheet is important to some, but the income statement effect of the lease is typically more important. The lease levels the capital charges (average rent expense replaces book depreciation plus interest expense for owned assets), and matches capital cost recovery with the EBITDA earned by the generating assets. For this reason, numerous generating companies have successfully executed leveraged leases on everything from baseload coal plants to natural gas fired peakers to pumped storage hydro projects. In addition, particularly in merchant power project leveraged lease financings, the lessor (typically a credit company like Tyco Capital (formerly CIT)) provides a tranche of subordinated financing at rates that compare favorably with the generating company's alternatives. However, most lessors have limited comfort with the proposition of owning a merchant power plant unless it is committed to a creditworthy power marketing company through a tolling agreement, or the merchant plant risks are otherwise mitigated in some fashion. The reason is that the lessor is concerned about lenders with a first lien on the generating asset, and that most financial institutions are not in a position to go into the market to sell the capacity, energy, and ancillary services their projects deliver. These issues have been successfully resolved, however, allowing generating companies to arrange financings for terms as long as 30 to 40 years.

Independent lessee transactions

If the lessee is owned by an independent financial party there are additional potential benefits to power generating companies. This alternative is a variation on the tax oriented leveraged lease. It potentially addresses certain accounting considerations, such as FAS #98. It also has certain earnings recognition benefits, matching development, construction, and operating period earnings to the period when the service is performed. This structure is somewhat unique, and has been arranged successfully by credit companies, such as Tyco Capital (formerly CIT).

Conclusions

Despite unprecedented ? and quite unexpected ? reversals in the power generating market over the past year, record levels of short term power plant construction debt to be refinanced, and the competitive power generation market has proven to be adept and resilient in responding to changing circumstances. Tyco Capital prides itself in offering creative long term financing alternatives to meet these challenges and the needs of power industry participants.