The NAFTA vision

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US generation players with experience of deregulation elsewhere in the world are fairly thin on the ground. Beyond the small numbers of UK utilities and producers that have decided to seek unregulated earnings away from the sluggish European market (Scottish Power and International Power being the most prominent), US independent producers and utility-based players have had the market to themselves. Alberta's TransAlta, with a growing US presence, has been through this process twice before.

Frank Hawkins, director of corporate finance and assistant treasurer at TransAlta, says that whilst his company's so far limited exposure to the US may help in the developing Canadian market, he prefers to look at TransAlta's experience the other way round. ?We think that our experience in Alberta ? and also in New Zealand ? will be very useful in the provinces and states as they begin to open up their markets?, he says, adding that ?there are a number of reliability councils where we still see opportunities.?

TransAlta began the change from a regulated to an unregulated producer at the beginning of 2000, with the announcement that it wanted to sell its distribution and retail businesses to focus on the higher-growth generation market. During the rest of the year it closed on the sale of its New Zealand assets (in March, to Natural Gas Corporation Holdings) and its retail business to Utilicorp Canada (in September). The process reached its zenith in the agreement of July 2001 to sell its transmission business (a part of the new strategic focus back in 2000) to a consortium of SNC Lavalin, Trans-Elect, Macquarie North America and the Ontario Teacher's Pension Plan. The partners in AltaLink paid $850 million for what was 10% of TransAlta's assets.

After this retrenchment, however, TransAlta shifted is unregulated plans up a gear. The first move was the acquisition in April 2000 of 50% of the Merchant Energy Group of the Americas (MEGA), which was started by Gener of Chile as its vehicle for US growth. MEGA has already played a key role in the acquisition of a 55MW peaker in Binghampton, New York. Gener, now in the hands of AES, sold on the remaining 50% to TransAlta in April of this year.

In May 2000 it created the core of its US business with the purchase of the 1360MW Centralia plant in Washington state for around $554 million. The deal included the plant's adjacent mining operations and represented a 13% increase in TransAlta's capacity base. The deal is a good fit in terms of fuel type for the producer ? the vast majority of its capacity is coal-fired, hydro or cogen. However, as its assets in Australia, Mexico and the US demonstrate, much of TransAlta's capacity growth will come from combined-cycle gas facilities.

It is not as cash-rich as the sales might suggest, and not only because much of the development work that it has done so far has been financed on balance-sheet. Some of the proceeds from the sales have been spent on reducing leverage and stock repurchases, of which TransAlta has carried out a number over the last eighteen months. And whilst management has stressed to analysts and ratings agencies that corporate-style financings are its preferred method of financing expansion, it does not have a huge balance sheet upon which to perch.

Its latest transaction is a case in point ? the sale of partnership interests in the Fort Saskatchewan cogeneration project.

This has been achieved by the public sale of units in the TransAlta Power general partnership, in an offering of units worth C$37million through CIBC World Markets and Scotia Capital. The proceeds will be used to buy out the parent's interests in the project, a joint venture with Air Liquide, and will be held through an intermediate vehicle, TransAlta Cogeneration L.P.

According to Hawkins, ?most of the issue is targeted at retail investors, although we are hoping to increase our institutional presence. We maintain control of the asset.? The issue highlights the still-shallow liquidity in the Canadian power market, where domestic banks are limited players, but does carry tax advantages. Moreover, the deal should increase to unit holders the cash distributions due, on which tax has been deferred to 2003. It does not carry all of the tax advantages of the unincorporated partnership, which has been a popular newbuild tool for cogeneration plants, but does provide stable cash flows and maintains the low risk profile of the asset.

The 120MW plant is located at a Dow Chemical facility in Fort Saskatchewan, in Alberta. It was commissioned in 1999, and its operations are covered by a utility services agreement with Dow through to the end of 2019. This agreement provides for sale of all steam and electricity output to Dow, a flow-through of fuel and operations and maintenance costs to Dow, as well as performance-based incentives.

The sale of the participation units, whilst streamlining distributions and simplifying the plant's ownership structure, serves a more mundane ? and familiar ? purpose. The sponsor realises that in a deregulating market it needs to free up as much capital from its contracted assets to use elsewhere. ?The deal is driven by the wish to redeploy capital in our generation business?, says Hawkins. ?We had a pocket of capital trapped here and this is the most efficient way to release it.?

Although Hawkins has not confirmed any plans for further deals of this nature, TransAlta does have a number of cogen plants in similar situations in Ontario. The 110MW Mississauga, 215MW Lloydminster, 68MW Ontario Health Sciences Centre and 70MW Windsor-Essex are all 50%-owned cogen plants whose capital might be redeployed. Hawkins says, ?these assets are tied up, and we're trying to get the right capital against the right assets, whether it's the PPA assets in Alberta, or the merchant output at Centralia.?

The main priority now for TransAlta is to find a flexible financing base for its growth in unregulated power generation. According to Hawkins, ?we will be using corporate finance as far as possible for our unregulated operations. This is the best method for maintaining operational flexibility in the business?. The inference is that banks should be looking to pitch corporate bond issues and corporate revolvers rather than the structured products that many new entrants use.

Communication with ratings agencies, whose verdict will have a crucial impact on the cost of corporate fundraising has been crucial, has been key task for TransAlta's finance team. Moody's Investors Service has rated the corporation at A3, although, following the news of the transmission asset sale, Standard & Poor's now has it at BBB+. Moody's accepted that the transmission assets made a relatively small contribution to earnings, and that 90% of revenues were contracted. S&P essentially says that the transformation to a pure generation company and increasing exposure to competitive markets makes a place in the A bracket unlikely.

Says Hawkins, ?our real issues have been with the ratings agencies, who we've had to assure that we're not a pure merchant generator. We still have a large and ongoing proportion of revenues coming from PPAs.? This, despite the fact that Moody's says that its peers are Edison Mission, Mirant, NRG, AES and Calpine, and the existence of a growing marketing business at TransAlta. Moody's adds that ?contrary to its comon practice for power companies, it considers TransAlta on a consolidated basis, and does not look at TransAlta's debt as being structurally subordinate to the senior secured debt at TransAlta Utilities.? It's reasoning is that refinancing of the utility debt, with is covered by the PPAs in Alberta that were written after deregulation, will be at the corporate level.

Project financing of the old school will largely be confined to ventures in Mexico. Rather like Sithe Energies, TransAlta will confine its construction activities to the North American Free Trade Association (Nafta) footprint. Given the protracted and messy financing process that accompanies plant development in other Latin countries, the decision appears to be a shrewd one.

The first success in Mexico came with the Campeche financing, which went out to 16 years in tenor ? a first for the country. An equivalent deal, the Termoelectrico del Golfo deal, went as far as 12, although it had a corporate, rather than quasi-sovereign, offtaker. Campeche, a $133.6 million loan, arranged by the Export Development Corporation and the Bank of America, is a masterpiece of risk allocation and sourcing political risk insurance.

The 250MW plant is located in the south of Mexico, far from the fast-growing industrial clusters near the US border, and subsists on a 25-year PPA with the Comision Federal de Electricidad (CFE), the nationalised electricity monopoly in Mexico. Multilateral lenders, however, have had their fill of exposure to the CFE credit, and for the first time were not present in the deal. ?It was harder than we thought, working without them, and together with the EDC we had to steer around withholding tax issues and a tight syndication process. But there wasn't an alternative ? the IFC, IDB and Opic were all closed,? says Hawkins.

EDC covered the political risk insurance needs for the project and managed to go beyond the normal limit of 15 years by means of some creative structuring with reinsurers. Surprisingly, the lack of a provider with preferred creditor status was less of a worry for lenders than making sure transfer and convertibility coverage was tight. The deal syndicated to arrangers ANZ Investment Bank and Industrial bank of Japan (IBJ), whilst the coarrangers are Bayerische Landesbank Girozentrale and Dexia Public Finance Bank, and lead managers are Fuji Bank and Helaba. Fuji Bank has since also closed a deal of Mitsubishi and Kyushu ? the $325.5 million Tuxpan deal ? but this came in at fifteen years and featured a high proportion of direct credit from JBIC.

TransAlta is now the preferred bidder on the Chihuahua II project, a 259MW gas-fired plant for which it was selected in March 2001. Estimated to cost $192 million, the plant is looking to line up Enron as a gas supplier. It should close on financing by the end of the year.

There are also several plants in the US where TransAlta might be able to use creative financing solutions, including the Sarnia cogen facility, the largest plant of its type in Canada and presently on the corporate balance sheet. The generator has also started work on an expansion to the Centralia facility that will run on natural gas. Since TransAlta, which is listed on the New York as well as the Toronto stock exchanges, reports its earning under GAAP, accounting-efficient structures may be possible.

According to Hawkins ?we haven't really got round to looking at synthetic leases, but are looking at other asset-backed structured financings. Defeased lease structures look useful, although you do give up some tax flexibility later on.? In the mean time, TransAlta will concentrate on the growing US market, where much of its planned expansion to 15000MW will take place. It has formed an ad hoc alliance with Warren Buffet's MidAmerican Energy Holdings to pursue opportunities, but structures will be determined on a case-by-case basis. On current trends, however, joining the ranks of the merchant players, whilst a slow process, is almost inevitable.