

AES Tiete: the mother of real deals

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2001 has seen a number of useful steps towards creating a suite of products to encourage IPP investment in Brazil. The two first two hydro-electric financings ? the Inter-American Development Bank-led Cana Brava and Dona Francisca deals ? the domestic project bond issue for the Ita hydro plant, and Enron's recent Riogen syndicated synthetic lease financing have all demonstrated to sponsors just what is achievable in the Brazilian market. But two big problems ? adapting gas-fired plants to the local market environment and accessing long-term capital ? appeared more insurmountable.

The \$300 million bond financing for AES Tiete looks set to provide a solution to difficulties in finding long-term dollar financing for real-denominated projects. It is the first long-term financing of a Brazilian generating company in the international capital markets. And much of this success comes down to the innovative first use of a devaluation insurance policy from the Overseas Private Investment Corporation (Opic).

Opic and Bank of America, which apparently pitched the agency on the bond product, have been working towards the creation of a viable insurance enhancement for some time. Power purchases in Brazil must be denominated in Reals, so that even a hydroelectric plant, with negligible operating costs runs the risk of a currency mismatch when repaying dollar-denominated debt. And devaluations in Brazil, often both the cause and the effect of emerging market malaise, are not an unheard-of phenomenon.

Tiete is a ten-dam hydroelectric generating company in which AES bought a 44% ownership stake (and 71% voting stake) in 1999. This was funded by a loan from the Brazilian National Development Bank, BNDES. The concession agreement requires that AES, as controlling shareholder, must develop further capacity in Sao Paulo, where the concession is located, before 2007. Since Sao Paulo is one of the fastest-growing regions in Brazil, such additions will no doubt be lucrative.

As with the Cana Brava project, much of the output of the project will be bought by another subsidiary of the sponsor, in this case Eletropaulo, which will initially account for 36% of output, but by 2006 will be the only contracted offtaker. 10% of the output initially goes to the spot market, where expected rationing should push up its price to very attractive levels. Other offtakers include EBE-Empresa Bandeirante de Energia S.A.(Bandeirante, owned by VBC and Electricidade de Portugal), CPFL-Companhia Paulista de Força e Luz (CPFL, VBC-controlled), Elektro-Eletricidade e Serviços S.A.(Elektro ? Enron), and two smaller companies ? Empresa Elétrica Bragantina S.A.(Bragantina)and Companhia Nacional de Energia Elétrica (Nacional).

Several of these companies are undergoing restructuring, how to treat the Brazilian subsidiaries of multinational energy concerns has exercised both bankers and ratings agencies.

For this reason, amongst others, bookrunner and sponsor were forced to do without a rating from S&P, which has been notoriously harsh on Brazilian corporates, including Eletropaulo. Moody's Investors Service rated the bonds Baa3, whilst Fitch rated them at BBB-. Eletropaulo may benefit from an upgrade later on in the year, and both sets of assets in any case provide a useful physical hedge in an environment where no-one can quite predict the winner out of the buy

and sell side of the generation game.

The timing of the note issue could have been better. At the time of the issue the American press was full of reports that AES was planning to halt \$2 billion in potential investments in new generation. Opinion is divided on the seriousness of AES' pronouncement, whether, in effect, the series of conference calls and releases were little more than a warning shot across the bows of the Brazilian government and regulators. It is certainly difficult to see AES jeopardising both the Tiete issue and any future role in the sector.

The tone of the announcements suggests that AES wants the regulator, ANEEL, to agree to honour the mechanism that it set up to index distribution tariffs to the cost of gas-fired generation. With a foot in both camps, AES cannot simply hope that offtakers will prepare to take a loss on power purchases. Nevertheless, when Enron also announced a postponement of planned investments (shortly after setting in place the aforementioned synthetic leasing arrangements for turbines destined for the country), talk of a power crisis has increased.

In the end, said a source close to the bookrunner, the sponsor decided to structure a ?clean, strong deal, both in terms of covenants and coverages. The coverages here are stronger than those for any other investment grade deal?. In the base case the average debt service coverage ratio is 2.39 times, whilst Moody's own discount to break even analysis has an average of 51%. Coverages are by and large lower in the early years of the debt.

The most significant part of the deal, the Opic policy, acts more like a revolving credit reserve, in that it remains stocked for devaluation-related liabilities of roughly \$30 million. If drawn upon, the issuer will repay the reserve after debt service has been taken care of. Some issues have been raised in the final position of the policy amongst intercreditor arrangements, and Opic can cancel the policy if AES falls short of various labour, environmental or corruption standards. Nevertheless, as Moody's notes, \$30 million is an exceptionally conservative cap. It says that had the policy been taken out in 1982, just before a particularly torrid time for the exchange rate, only \$5 million would have been called upon.

One thing that might exacerbate any drawdown would be the effect of a devaluation upon a gas-fired plant. And, as with other structural innovations in the Brazilian power market, application to a thermal plant remains elusive. A gas generator would be hit twice ? on both debt service and fuel costs ? and AES and Enron, alongside El Paso as the most aggressive investors in the country, have already warned of a lack of patience with the state of the market. Nevertheless, most of Opic's groundbreaking bond transactions in Latin America have been rapidly copied. Tiete will be no exception.

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