We are devo

01/04/2001

The AES approach slashes through conventional power industry management thinking ? a strategy rooted in a radically decentralized corporate structure, quite unlike that of most other industry contenders.

To begin with, no investment is centrally coordinated; executives in the field make almost all their own decisions; their decentralized management structure gives them a flexibility that has created some of the highest returns on equity in the industry. In fact, the company's return on equity has averaged 20% annually over the last five years, a trend that AES predicts will continue, and its market capitalization puts it around $28.5 billion.

Moreover, each project is treated as a separate business. Explains Barry Sharp, AES' CFO, ?the principle which is really fundamental to our discipline and which we've stuck to since the beginning is evaluating and thinking about each business on its own terms.?

What this means in practical terms is investing in each project on its own basis, treading on new turf with a view to simply ?trying it and seeing if it works,? without a view to maximize profits ? or so the claim goes. And it has, almost without exception, worked (with the added bonus of unprecedented profit). The company took off by aggressively building and, later, buying plants. It now has interests in 153 facilities with 53,000MW of capacity in over 20 countries. The company has more than 50,000 employees and continues to by up generation and distribution assets worldwide ? from Pakistan to Chile, from Nigeria to Hungary ? as well as the US.

?We're in this business for long term returns,? explains AES Enterprise president John Ruggirello. But the fact that the company's expansion has relied heavily on massive debt requirements has called for certain pivotal factors to streamline the AES approach, and to convince lenders of its viability. Aside from structuring each of its projects as a financially separate business, the company has by and large appealed to non-recourse project finance. Project debt, at $15 billion, makes up 47% as a percentage of AES' total assets, while corporate debt totals 11%.

AES has also been a vocal proponent of long term contracts to supply power to the market, a fact that, argues Sharp, provides certain clear cut revenue assurances. In other words, it is only prepared to pay for clearly defined risks.

The idea is simple: if AES can improve the efficiency of its generating facilities, while structuring highly tax efficient deals, there will be ample cash to cover debit service, with plump profits left over for the parent. Its typically stringent availability targets, for example, are met by cutting edge technological innovations. But as crucial to securing AES' dominance is its diversification. By operating in so many parts of the world, AES has insurance against a single big economic setback that would hit the parent company hard.

The ratings game

As Moody's puts it, ?the sheer size of the company and the diversity of its international investments begins to lend some stability to the cashflow of the company.? But, it cautions, ?the high leverage, the regional concentration and the

relatively low coverage of debt payments keeps the rating below investment grade.?

In theory, the lower a rating, the higher the price of debt. And lower ratings for many power sponsors may stymie their development plans. This, however, is less of a concern for AES.

?Ultimately our portfolio will have to be investment grade,? says Ruggirello. But AES downplays the extent to which this may be an issue, remaining buoyant in its outlook. ?Our history, our continued growth and our steady improvement in cashflow both locally and overseas will eventually have us reach it,? he maintains. But, he adds, ?this is not the most critical point. What's more important are the overall economics of each project, which to date have been generally optimal.? And although its insistence on non recourse debt will continue to grow, so too will its equity components which, argues Moody's, will likely result in increases in coverages and a further shift towards investment grade.

?Our bias,? explains Sharp, ?is to do each financing separately, non-recourse, and then to let each project stand on its own.? The reason for this is flexibility. ?We don't have a centralized project finance team that dreams up innovative solutions to possible situations and then tries to apply them, as others might. The finance doesn't drive the business. The business drives the finance,? he argues.

Underpinning this argument is a wholehearted belief in free markets and the intrinsic value of competition. ?We rely on competitive environments to allow us to win a competition,? proclaims Ruggirello. ?And that approach applies across the board.?

Home turf

AES is the leading private power generator in the United States. And it looks set to maintain that foothold, with further acquistions and greenfield developments planned, adding to an already formidable generating asset portfolio of 7500MW capacity, with up to another 3000MW currently under construction, not to mention sizeable distribution assets. This, despite what many analysts expect to be a year of volatility for many electric utilities in the wake of deregulation.

New England and Texas are two areas where some analysts expect certain market sensitivities to prevail ? planned peak capacity additions allegedly exceed the regions' peak demand and transmission constraints limit the ability of local utilities to wholesale their excess out of the region. They are also two areas in which AES is currently developing additional megawatts.

Construction on the first plant, the Wolf Hollow project in Texas, began several months before its expected financial close. Scotia bank picked up the mandate to arrange the facility's $300 million debt requirement, scheduled to hit syndication shortly. 350MW of the plants 730MW will be tied up under a 20-year tolling agreement, with the remainder sold in to the merchant market. Gas supplies will also fall under a long term contract.

In New England, the Granite Ridge facility in New Hampshire, recently reached financial close, lead arranged by ABN Amro. Granite Ridge is a 720MW combined-cycle gas-fired plant, expected to be completed in time for the peak summer demand in 2002, thereby exploiting projected high power prices at that time.

Referring to possible future market directions in the US, Ruggirello points out, ?we're active to different degrees in all 10 US markets and we'll be happy to develop projects wherever they're needed.? One obvious region would be the south-east. ?That's where the herd seems to be moving, given the opportunities there,? adds Ruggirello, ?and we'll certainly bring our skills to bear when the competition arises.? In fact, the company secured three turbines last year for an as yet undisclosed project it is currently pursuing in the southeast, a deal which also underscores a growing trend in the US towards non-recourse turbine leasing.

Notwithstanding the Federal Energy Regulatory Commission's (FERC) recent scrutiny of AES' activities in California, the state's debacle has caused further concern for the company, in part because it indirectly lead to the blocking of its purchase of the 1580MW Mohave Generating Station by the California Public Utilities Commission (PUC). The station, owned by Southern California Edison, was to have been sold to reduce some of the company's unwieldy debt burden, and AES was keen to secure more ground near the Californian market. CSFB was looking into the possibility of arranging a $960 million loan for the deal when the PUC stepped arguing that it could not sanction further sell offs while the power crisis in the state continued. Says AES, ?we believe the deal makes a lot of sense for the state and the utilities, since we intended to contract power back to California.? The transaction has been postponed indefinitely.

Case to contract

AES is eager to emphasize its preference for long term contracted offtake agreements, as opposed to selling its output directly to merchant markets. Merchant power is clearly a growth industry in the States, with some estimates suggesting that eventually 20% of the country's electricity supply will come from this market, though by 2004 it is likely to account for no more than 9% of AES' earnings. But, according to Sharp, AES' rationale is clear: partially hedged or semi-contracted structures offer more solid earnings potential.

Indeed, California is one region where, as Sharp points out, ?the bias is, unequivocally, still to be hedged in terms of long term power sales agreements or tolling agreements.? In financing projects in newly deregulated markets, many would contend that, given the inherent unreliability of market price forecasts, the mitigation of commodity pricing risk is the fundamental issue. And contracting can help utilities control their costs by fixing the bulk of their most predictable costs at reasonable prices. These same contracts can then give generators reasonable assurances they can actually recoup their investment and earn a favorable return.

Sharp expounds, ?the longer term lessons of California suggest to me that because of the nature of the commodity, buying under longer term contracts is really the way to do it. It is sustainable, it is long term. And it protects against volatility.? He adds, ?over time, as the market works and transparency happens, there will be a broader portfolio of different length contracts.? This, in theory, should hold true anywhere.

As important for future AES developments both in the U.S. and, for that matter, around the world is fuel. Says Ruggirello, ?of course we're looking at CCGT plants, but also at coal and pump storage facilities. We're not wary of any type and so we don't lock ourselves into any one type.? Given the diversity of its fuel portfolio, AES has spared itself exposure to recent jumps in natural gas prices. Continues Ruggirello, ?This impacts positively on the pricing of solid fuels. And as we continue to reduce emissions, our fleet becomes ever more competitive.?

Latin test

The AES approach faces a possibly more profound challenge as the company moves more deeply into Latin America's deregulated, often turbulent energy markets, raising power plant investments there to more than $7 billion just as its economies are facing soaring debts and slower growth.

AES views Latin America as a key source of future earnings growth. And last year it did five major deals in Latin America, in addition to several other consolidations in the region. AES's outspoken emphasis on social responsibility also resonates strongly with populist Latin leaders, and, to some extent, may have let the company sidestep some of the hostility many foreign (particularly American) companies face throughout the region.

To AES, operating in erratic emerging economies is not simply a calculated risk, but rather an integral part of the corporate mission of ?selling electricity where it is most needed?. As for specific activities in last year's Latin buying spree, AES increased its ownership of in Argentine generator Hidroelectrics Alicura to 98%, through a $205 million purchase of 59% from Southern Co, and a $9 million purchase of 19.5% from the government. Future developments will

likely focus on improving optimizing control over Parana, while improving the results of other discos. Says Sharp, ?we see some opportunities for improvement but not too much for further growth.?

In Chile, AES purchased 98% of generator Gener for $1.056 billion through a public tender. ?This is a newer market for us and we are by no means the dominant player, but certainly with Gener there are ample opportunities for us to optimize,? says the company. Gener is Chile's second largest producer of electricity and its largest producer of electricity from thermal power plants. It has 1,370 MW of installed thermal generating capacity in Chile. But is also has electricity production and distribution assets in Argentina, Colombia and the Dominican Republic.

It plucked the Venezuelan genco/disco Electricidad de Caracas (EDC) for $1.56 billion, in a hostile takeover. And, for $53 million, it picked up KMR power, ?a reasonable, low cost player? which owns three natural gas fired generators in Colombia.

In other recent advances, AES, together with EdF, moved to take over Reliant's interests in Light Servicos de Electricidade. At $430 million, AES snapped up 30% of the stake, with EdF taking the remainder. This follows AES' purchase of Reliant's El Salvadorian interests, backed by a $100 million non-recourse loan from Dresdner. Light has interest in both generation an distribution in the populous region around Rio de Janeiro, and has around 2.9 million customers. It also brings the greater bonus of 4.5 million Sao Paulo customers, through a controlling stake in Eletropaulo, which, along with rapidly growing telecoms business, is AES' main rationale. Says Sharp, ?Eletropaulo will continue to occupy most of our time,? though there are likely to be other acquisition opportunities.

AES also focused last year on refining its interest in AES Tiete, the Sao Paulo generator that complements Eletropaulo. AES picked up the initial 62% chunk of Tiete in 1999, financed in part through a $188 million non recourse BNDES loan. It then took a further $50 million shares the following year, while radically cutting back its workforce.

Brazil fits squarely into AES' development map. As Sharp puts it, ?we're very gung-ho about Brazil.? The company is keeping a close eye on future privatizations, in particular that of Sao Paulo generator Cesp. But as importantly, it has located three new sites for greenfield developments in the country. The first project, the 1,000MW combined cycle Santa Branca plant, will lie just outside Sao Paulo. Gas will come from the Bolivia-Brazil natural gas pipeline, and the plant should come on line by mid 2003. The second is the 750MW combined cycle Bariri plant, also to be situated in greater Sao Paulo, with commercial operations expected to begin by the third quarter 2003. The final plant is the 750MW TermoSul plant in the Rio Grande do Sul region. Each plant is likely to cost in the region of $550 million, with non or limited recourse debt financing likely to be multisourced from commercial and multilateral lenders.

Further north in Central America, AES appetite is equally rabid. In September, it started construction on a $340 million generation plant and liquefied natural gas (LNG) importing facility in the Dominican Republic.

Last June, AES also obtained $815 million in nonrecourse financing for a circulating fluidized bed coal-fired facility currently being built on the south coast of Puerto Rico.

The financing, a mix of bank debt, institutional and long dated tax exempt bonds, backs a plant secured by another AES-style long term contract. The project is noteworthy in that highlights AES approach to cultivating tax savings while also underscoring the company's aggressive search for coal contracts. Interestingly, the plant is allegedly used by the EPA as a standard of cleanliness.

But one of the biggest, and most exciting, projects looming on the regional horizon is in Honduras where AES is building a $650 million, 750 MW gas-fired power facility that could cut electricity costs by up to half throughout Central America. It is hoped that by 2003 the plant will supply power to Honduras, Nicaragua, El Salvador and Guatemala ? at $0.05/kWh, half the current market price.

Given a lack of Central American gas reserves, AES also plans to build an LNG terminal and storage facility (from Venezuela and Trinidad and Tobago) beside the power plant at Puerto Cortes, on the Caribbean coast. The power plant will supply only 25% of its electricity to Honduras, with El Salvador, where AES owns four distribution companies, taking 40% and Guatemala taking 20%-25%. Nicaragua, and possibly Costa Rica and Panama, will take the rest. AES will also build a 231-mile transmission line to take the electricity to El Salvador.

AES's plans for Central America are vast and bold. But they fit well with the company's strategy of investing in high-risk developing countries which offer immense opportunities for development. The six countries of the region have a population of 35 million people and a combined GDP of more than $55 billion. But all the region's power is currently generated by small, costly and unreliable facilities. In response, the AES project envisions a single electricity market and power grid in Central America by 2006.