Iron Duke

01/02/2001

?We think that that the year 2000 closed successfully for us and that we will see continued growth in the year 2001.? The usual company line from David L Hauser, vice-president and treasurer of Duke Energy ? but with a twist. It is actually true.

Last year was a tremendous year for Duke. The company operates a traditional portfolio of natural gas and electric supply, delivery and trading businesses, which generated revenues of $49.3 billion for the year 2000, a 127% increase over the previous year. Earnings before interest and taxes (EBIT) increased 29% to $3.7 billion during the year.

One of the highlights of the year was the Duke Ventures business segment, comprised of Crescent Resources, DukeNet Communications and Duke Capital Partners, reported third-quarter EBIT of $444 million, a 1,486% increase over the $28 million earned in the same period last year. The increase is attributable to gains realised on the sale of telecommunications interests and industrial property.

?Our telecommunications business is growing. But it is not growing any faster overall than our other businesses. There is no projection that we should expect the telecommunications business to grow any faster than any other part of our overall business,? says Hauser.

Duke Capital Partners is a newly formed wholly-owned merchant finance company, that provides financing, investment banking and asset management services to wholesale and commercial energy markets.

In July, Canadian 88 Energy Corp arranged and closed a $215 million credit facility underwritten by Toronto-Dominion Bank and Duke Capital Partners. Proceeds of the credit facility were to be used to retire existing bank debt and for general corporate purposes. A portion of the secured credit facility was to be syndicated immediately, led by TD, and a further portion replaced within 90 days by a subordinated term loan which Duke Capital arranged and syndicated. Duke Capital Partners and Duke Energy Hydrocarbons hold a 19.4% stake in the borrowing company.

Hauser says the Duke Capital unit is not just an internal financing mechanism. ?We may have an equity stake in the companies that Duke Capital finances. But that is not a requirement. But we would have to have a business relationship with the company. For instance, if there was a gas producer that was going to sell us some product, we might make a loan to them to do their initial drilling.?

Hauser adds, ?GE Capital actually started in a parallel way to the way we started. You can't say how the business will operate 20 years from now. But right now, financing through Duke Capital Partners is confined to companies that we have a business relationship with.?

GE Capital has energy investments exceeding $5 billion in most segments of the energy sector, including power generation, pipelines, transmission and distribution, refineries and oil and gas reserves. That company provides capital to the upstream oil and gas community incidental to equity stakes or business relationships.

Under its commercial paper facilities and extendable commercial note programmes, Duke Energy had the ability to borrow up to $5.7 billion and $3.3 billion at September 30. ?We have strong relationships with a lot of banks, including about 30 in our credit facility,? Hauser maintains. Duke's $2 billion revolving credit facility is led by Salomon Smith Barney and includes Canadian and European banks as well as US institutions. However, some of the major banks that have signed on to Duke deals last year are Bank of America, Bank of Montreal, Barclays, Chase. Citibank, First Union, First National of Chicago and Wachovia. Duke went to the banks a number of times last year. Hauser says the company's 364-day revolver will be up for renewal this summer. ?The five-year facility still has several years to run,? he adds.

?I would not consider any one bank as our lead bank. We have several banks with which we have outstanding relationships and historically have not discussed those relationships.? In September, Duke Energy issued $250 million of 71/8% remarketable or redeemable senior notes. At the option of the remarketing dealer, the notes will either be redeemed in 2002 or remarketed and extended for an additional 10 years. In August 2000, Duke Energy Field Services (DEFS) issued $1.7 billion of notes comprised of $600 million of 7½% notes due 2005, $800 million of 77/8% notes due 2010 and $300 million of 81/8% notes due 2030. The proceeds were used to repay a portion of the $2.75 billion of commercial paper issued in connection with the Phillips acquisition. Lead underwriters were Merrill Lynch and JP Morgan. In March, Duke Energy issued $300 million of 73/8% senior notes due 2010.

Also in March, Duke Energy, through a wholly-owned subsidiary, completed the approximately $1.7 billion transaction that combined the DEFS gas gathering, processing and marketing business with Phillips Petroleum's Gas Gathering, Processing and Marketing Unit to form a new midstream company, named DEFS. In connection with the combination, DEFS issued approximately $2.75 billion of commercial paper in April 2000. The proceeds were used to make one-time cash distributions of approximately $1.53 billion to Duke Energy and $1.22 billion to Phillips Petroleum. Duke Energy owns approximately 70% of DEFS and Phillips Petroleum owns approximately 30%.

?We use a certain amount of leasing but only in instances where we can see a unique advantage,? Hauser says. ?We have acquired some aircraft ? for our own use ? using synthetic leases.? Hauser adds that the use of finance structures reflects how long a company has been in business as well as its creditworthiness. ?If you take a look at any company at startup, and then after it has been established, you will see that financing methodology changes as their balance sheet changes.?

During the third quarter, DEFS filed a shelf registration statement with the US Securities & Exchange Commission (SEC) to offer up to $2.0 billion of long-term debt securities and then issued approximately $1.7 billion of long-term debt securities under this shelf registration. The proceeds from these securities were used to reduce the balance of the commercial paper. As a result, the $2.8 billion commercial paper programme was reduced to $1.0 billion.

?Our relationships with all these banks I would characterise as positive. However, you certainly will go through times where a particular bank will have a lot of credit exposure to your company and is reluctant to take on more exposure, which makes things tougher.? Hauser says that, in general, banks will stay with Duke and are eager to look at whatever financings come up. ?Reluctance by particular banks to enter deals shifts as the amount of exposure shouldered by those particular banks shifts. So it's never a question of a relationship deteriorating between a particular bank and Duke as much as it is the exposure level that a particular bank is comfortable shouldering.?

Duke has also been active outside the US. ?International activity was a step slower in 2000. However, we are still very active internationally. We concluded the deal for the Dominion assets in Latin America. We concluded the construction of the EGP pipeline. And we bought out the minority shareholders of Paranapanema.? Much of Duke's activity during 2000 included closing transactions that had been started in the previous year.

In November, the Duke Energy International (DEI) business unit completed and began commercial operation of a $75 million expansion and modernisation of its Acajutla power generating facility in El Salvador. The plant modernisation and expansion includes the installation of an additional 100 MW of generating capacity, bringing the total capacity of the plant to 300 MW. Duke Energy's total generating capacity in El Salvador is now some 400MW or approximately 15% of the total generation in the country. Hauser says the company's interest in El Salvador was spurred by the country's political and economic stability. The Acajutla facility was acquired in 1999 by DEI as part of a privatisation of government-owned electric generation assets.

In August 1999, Duke Energy, through its wholly-owned subsidiary DEI, reached a definitive agreement to acquire Dominion Resources' 1,200MW portfolio of hydroelectric, natural gas and diesel power generation businesses in Argentina, Belize, Bolivia and Peru for approximately $405 million. The purchases of the businesses in Belize and Peru were completed in 1999. In March and April 2000, DEI completed the purchases of the businesses in Argentina and Bolivia. ?Our overseas businesses are very much integrated businesses. In Australia, for example, it's pipeline, electric generation, trading and marketing rolled into one.?

Also in August 1999, Duke Energy, through its wholly-owned subsidiary DEI, entered a series of transactions to complete the approximately $760 million purchase of a controlling voting interest and an approximate 44% economic interest in Companhia de Geracao de Energia Eletrica Paranapanema, an electric generating company in Brazil. In January 2000, Duke Energy completed a tender offer to the minority shareholders of Paranapanema and successfully acquired an additional 51% economic interest in the company for approximately $280 million. This increased Duke Energy's economic ownership from approximately 44% to approximately 95%.

In November, DEI announced that it had secured board approval and identified the customer base to support the $380 million Tasmanian Gas Pipeline. Construction will start in mid-2001 pending finalisation of environmental, licensing and regulatory approvals. The offshore pipeline construction contract will be let in early 2001 with the onshore construction contract let by mid-2001. The pipeline will start at Longford in Victoria, cross Bass Strait and come ashore in the region north of George Town. The 305km offshore pipeline will rest on the bed of Bass Strait, while the 430km onshore pipeline will stretch to Port Latta in the northwest, and to Hobart in the south. The pipeline is expected to be completed in the first half of 2002. Gas will be sourced from Esso Australia Resources and BHP Petroleum (Bass Strait) Pty Ltd in Victoria, both of which have demonstrated adequate long-term reserves.

?We are very centralised in our financing. The purpose of that is that we are very much focused on optimising the company rather than just optimising a single project. We have used project finance and we will continue to use it in the future. In general, there have been companies, that in order to go bid on a project, had to line up banks to project finance. That creates a lot of work. Our approach always has been to use our balance sheet to buy whatever assets we deem appropriate. So we are the ones that decide when we are going to use project finance. We realise that the effort needed to be expended to get project finance across the finish line is considerable,? Hauser notes.

Hauser is adamant that the development of merchant plants in the US is a key component of Duke's development programme. Duke Energy North America (DENA) delivered four new US merchant facilities totalling 2300 MW in the summer. At the same time, Duke/Fluor Daniel delivered eight projects world-wide and garnered the largest share of the fossil fuel generation market in the US Overall, Duke Energy grew non-regulated businesses earnings 222% over the first three quarters of 2000 compared to last year. Hauser said Duke also was keeping an eye on developments in Florida. ?While we don't see any advantage in speculating on what is going on in the state concerning whether merchant plants will be allowed to operate, we are very interested in being able to enter that market when it opens.?

Strong year-end results provide proof that the company's power trading and wholesale power generation ventures are also successful. These unregulated operations are expected to continue growing at a quick rate, given that Duke is likely to capture a large portion of the growing market for unregulated power generation and power trading. ?However, we have no intention of abandoning regulated businesses in favour of unregulated businesses,? Hauser emphasised.

The California electricity supply crisis is a top priority for Duke. ?We are watching the California situation very carefully.

We are helping them solve their issues. Duke will add capacity to the California market,? says Hauser.

In December 1999 Duke closed its Californian $470 million merchant portfolio financing arranged by CSFB, SG and Bank of Montreal. And in late July, Duke Energy North America (DENA) committed to deliver 3,000 MW of new supply to California and a five-year fixed price supply contract to incumbent utilities to address the immediate concern with volatile electricity prices. DENA, a wholly-owned subsidiary of Duke Energy, is a wholesale energy services company which provides natural gas and power supply and services, and risk management products to wholesale energy producers and users. DENA also develops, owns and manages a portfolio of merchant generation facilities.

?Our proposal was not accepted. And the price of gas has gone up dramatically.?

Duke Energy submitted subsequent bids on January 24 in the California Department of Water Resources (DWR) Request for Bids (RFB) for Energy Purchase programme. Terms of the bids were not disclosed in accordance with the confidentiality restrictions in the RFB. Duke Energy entered its bid through its trading unit, Duke Energy Trading and Marketing. ?There were a number of requirements connected with this bid ? both in time horizon and in number of hours per day.? Companies made bids for various combinations of days and hours, such as seven days, 24 hours; and, six days, sixteen hours. ?While companies are anxious to enter the California market,? says Hauser, ?there have been no public reports of any joint ventures with existing companies in that market.?

But someone will have to do something soon in California. The state's two largest utilities ? Pacific Gas & Electric and Southern California Edison ? are on the brink of bankruptcy, unable to pass along to customers soaring wholesale power costs. Both companies have defaulted on short-term debt and their credit ratings have been downgraded to below investment grade. California is now experiencing rolling blackouts. ?The ball is now in the court of California's legislature,? says Hauser.