Electro retro

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The challenge facing much of Central and Eastern Europe in the power sector is not adding new generating capacity to the system, but cleaning up and modernising existing power stations, many of which still use Soviet-era technology from the 1970s.

This is particularly true of the countries that are soon expected to join the European Union. Even though the likely accession date has slipped beyond 2003, these countries are still under pressure to speed up their environmental clean-up process in areas such as the Black Triangle, the coal mining region where the borders of the Czech Republic and Poland meet Germany.

Retrofits and the installation of better pollution control equipment are being primarily led by large foreign power companies, notably from Germany, France, the United States and the UK, who have not only participated in the privatisation process but are also engaged in strategic mergers and acquisitions. But more privatisations are needed in countries such as Poland, where two-thirds of the total installed capacity of 33GW still needs modernising.

Another driver of change is that the accession countries have to liberalise their power sectors to meet the guidelines set out in the EU Electricity Directive. But liberalisation is making life more complicated for project financiers in the power sector, who have grown used to lending against long term Power Purchase Agreements (PPAs) signed with state owned grid companies such as Polskie Sieci Elektroenergetyczne (PSE) in Poland and Magyar Villamos Muvek (MVM) in Hungary.

Now lenders are having to look at other buyers such as large industrial customers, or take merchant risk by having PPAs which will only partially cover debt service. This uncertainty has led to a slowdown in power project financings during 2000, and 2001 will be a critical year in establishing templates for the next wave of power sector financings.

?One or two transactions will probably run into difficulties before the market understands how to structure these deals, but I think they are do-able,? says Albert May, head of corporate finance at Citibank in Warsaw. ?It is back to basics. The kind of things we are looking for are an operator and a project that makes sense from a strategic point of view, from a geographic location point of view, and from a supply and demand point of view. In Poland most of the power projects are supplied by coal, so having a long term stable coal supply contract is of high importance, so at least on the input side a guarantee of prices being there for a relatively long period of time.?

?We also look at the operator to see if historically they have had the technology and the capacity to operate a plant efficiently, and see what the cost dynamics are. These project financings are usually for tenors of 10-plus years, and it is not precluded that 10 years from now they will have to compete with western power supply,? May explains. ?We would look for reasonable offtakers on the other side. The grid is not available any more as an offtaker, but that doesn't mean you cannot negotiate a series of long term offtake contracts which have some substance.?

In fact bankers argue that the changing rules of the power game represent the beginnings of true project finance in

Central and Eastern Europe. ?Some local banks have been willing to lend on a corporate basis, so project finance elements have been lacking,? says Andrzej Kopyrski, head of structured finance and fixed income at ABN Amro in Warsaw.

Meanwhile, as power companies have been privatised, the entry of well known foreign sponsors such as RWE, Electricite de France, Tractebel and Vattenfall have brought their relationship banks in with them, and these banks have used high profile syndications to establish themselves in the regional banking sector. They have usually found themselves competing with half a dozen other project arrangers on any high profile deal, and have generally been willing to be very aggressive in order to win mandates.

Thus power projects have been able to obtain tight pricing as well as favourable terms and conditions, and bankers foresee that along with the changes associated with liberalisation there will be a move towards tighter covenants in 2001.

Poland

At the moment in Poland electricity prices are governed by an independent regulator, with PSE having a monopoly in transmission, and acting as the single buyer. But in order to comply with EU regulations on liberalisation of the market, the Polish government is in the process of looking at new market-based pricing structures.

?Bidders and lenders want to clear picture of how the energy market is going to look,? comments Piotr Kowalski at the Central European Rating Agency (Cera) in Warsaw, who points out that some big decisions on matters such as privatisation and electricity market deregulation are likely to be held up as Poland gets its upcoming parliamentary elections out of the way.

The new laws will have to involve some sort of stranded cost compensation for the generators with existing long term PPAs, and talks are continuing between project sponsors and lenders about compensation payments. ?The banks have a security assignment over the receivables from the contract signed with the Polish Grid, so there is a substantial change of collateral,? says Krzysztof Szyszko, director in project finance at Kredyt Bank in Warsaw, a bank owned 48% by KBC of Belgium and 20% by Banco Espirito Santo.

But Szyszko views some of better modernised power plants as still being finance-able, even without PPAs. ?The best power plants in Poland will be worth analysing even without a long term 15-year PPA, if they have top sponsors and good cost efficiency,? he says.

During 2000 the emphasis has been upon closing the last of the old-style PSE-backed transactions, and in early November project sponsor PSEG Global announced the closing of its financing for the Elcho facility located in Chorzow in Upper Silesia.

The combined heat and power plant will replace one of the country's oldest established heat and power generators, Elektrownia Chorzow, which will continue to operate during construction. The total cost for the project is estimated at $324 million, and commercial operation is scheduled for 2003. PSEG Global holds a 90% economic interest in Elcho, with Elektrownia Chorzow holding the other 10%.

Elcho has a 20 year coal supply agreement with Nadwislanski Wegiel SA, which is based in Tychy, and will deliver one million tonnes of coal a year from its mines in Upper Silesia. With the help of advanced circulating, fluidised bed boiler technology provided by Foster Wheeler the plant will be able to burn this low quality coal while meeting stringent environmental standards.

PEC Katowice, the district heating company serving the city of Katowice and its surrounding communities, has committed

to purchase the heat generated by the plant. And the Polish Power Grid has signed a 20 year power delivery agreement to take all the power- supposedly one of the last PPAs signed by the Polish Grid.

?There is a long term PPA, and the banks are comfortable with security over the receivables,? says Michael Davies, partner at law firm Allen & Overy in Warsaw, which acted as counsel to the lenders.?It is one of the last deals to benefit from a long term contract with the Polish Power Grid. From now on, deals will have perhaps four to five year contracts with various offtakers.?

Dresdner Kleinwort Benson was the sole lead arranger and underwriter on the project financing, which comprised a $193 million dollar denominated loan, and a $76 million zloty denominated tranche.

This mixture of dollar or euro plus zloty tranches is typical of the power sector in Poland. Local banks can provide sizeable financings, but they quickly run into concentration issues with regard to big borrowers, so even when zloty rates were lower they were still forced to look outside Poland for financing. ?The power stations usually finance themselves with foreign currency syndicated loans, since the Polish banks are not big enough to finance projects on their own, and there are also limits of concentration on the part of the banks,? says Wojciech Lipka at Cera in Warsaw.

Another large loan syndication which closed earlier this year involves the vast complex at Turow, a 2000MW facility which dates back to the 1970s and has been upgraded and expanded in stages. Nine of its ten 200MW units are being upgraded, and the new fluidised coal bed technology being installed by firms such as Foster Wheeler will represent an important step towards reducing air pollution in the Black Triangle.

?The entire plant is being renewed, and will produce more power while also being less polluting,? explains Davies at Allen & Overy, which has acted as adviser to Turow on the three phases of its financing. ?Turow is regarded as having a favourable PPA, and this PPA is crucial to the financing.?

The latest syndication of a zloty denominated loan for Turow was closed earlier this year, led by Handlowy and Pekao. There was a domestic zloty tranche equivalent to $250 million, plus a $100 million dollar tranche. Turow is also hoping to complete a project bond offering in the near future, with the transaction to be led by UBS Warburg and Schroder Salomon Smith Barney. If it gets done, the planned $250 million bond offering, which is being rated by Standard & Poors, will be the first power project bond out of Central and Eastern Europe.

But undoubtedly the absence of long term PPAs will, at least in the short term, slow down the pace of financings being closed. ?Everyone wants to get rid of PPAs and bring the price of electricity down, but they also need to get capital into the sector and, for investors in this region, long term, PPAs are very important,? says Davies at Allen & Overy. ? Privatisations have punchy capital investment commitments, and so while privatisations are delayed so getting financing into the sector is also delayed.?

One example of a deal without a long term PPA which has had trouble closing is the privatisation sale of a 35% stake in the Rybnik power plant. Earlier this year General Electric withdrew from the privatisation consortium, but the treasury still hoped to make a sale to the remaining two members, NRG and Marubeni Corporation. The exclusive negotiating period expired on 31 October, and the treasury re-opened the tender process.

In addition to being one of the first deals without a long term PPA with the Polish Grid, the original consortium had difficulties lining up suitable long term coal supply agreements. Rybnik is probably the first illustration of how the next generation of Polish power deals are going to present hefty challenges for both equity investors and lenders.

Hungary

Another country expected to be at the forefront of new entrants to the EU is Hungary, and it is also in the midst of a

sweeping review of the electricity market structure in order to meet the terms of the Electricity Directive.

The big question is whether the foot dragging on the part of the EU over its eastward expansion will result in slower pace of liberalisation and environmental cleanups. ?Liberalisation is EU driven, it is not because we need more electricity generating capacity,? explains Dr Eva Hegedus, partner at Allen & Overy in Budapest. And her colleague Dr Marcell Nemeth adds that ?the response from the government is that if Hungary is not going to enter the EU at an early date, then it is not so urgent to liberalise the power sector, so project finance in the power sector has slowed down.?

PricewaterhouseCoopers (PwC) is official advisor to the Ministry of Economics on the Hungarian Energy Liberalisation Program, which will look at both electricity and gas. ?The first area being looked at is electricity, and the main driving force is EU compliance,? explains Tibor Almassy, partner at PwC in Budapest. ?We are also working on the identification and measurement of stranded costs, which is likely to be an important issue.?

Other industry players say that apart from stranded costs the big issues to be decided are what sort of market mechanism to use for generation and transmission, plus the timing of its introduction. The electricity generators have been in discussions with the government over the entire stranded costs issue. Some players carried out expensive retrofits on old power stations, signing contracts that allowed them to build a new facility alongside. The cancellation of these licences to build new units, or the refusal of MVM to approve PPAs on which they rely, has led to some public disagreements, notably involving AES whose battle has ended up in the courts.

Hungary actually has little need for new capacity, and activity is more centred upon M&A of existing power plants, plus retrofits to reduce air pollution. However the national power grid company MVM launched a capacity tender in 1998, and some sponsors proceeded with expensive retrofits on the basis they would then be able to build extra units.

But ? especially with added nuclear capacity such as the Paks Nuclear Power Plant ? MVM is not short of capacity. ?Even with the new nuclear plant, MVM thought they would need more capacity. So they launched several tenders. But they have now realised that they will need less new capacity, and are re-evaluating their power needs,? says Andras Hanak at Dewey Ballantine in Budapest, whose advisory roles have included the Tractabel Duna Menti power plant, the largest in Hungary.

But in spite of all the uncertainty, M&A activity continues. Budapest Power is being sold by Fortum, while Powergen is selling Csepeli. Players such as RWE of Germany and Electricite de France are heavily committed to the Hungarian market.

One deal which may serve as some sort of model for future financings is the power plant financing for Borsodchem. At 49MW it is just below the ceiling where a government licence is needed. This Eu300 million gas fired plant produces some electricity, but mainly produces steam for its affiliated chemical industry offtaker, and because it is only 49MW it is too small to require a government licence.

The sponsors are RWE unit Emasz, which is a distribution company based in the north of the country, plus the Borsodchem chemical concern which needs most of the steam for its factories, together with state owned gas company MOL which is supplying the gas. Local municipalities are also taking some electricity and steam.

The loan financing closed in the middle of 1999, led by BNP Dresdner. The European Investment Bank was involved as a lender on a 15-year loan, and there was also support in the form of a letter from RWE. This made the banks comfortable, though Zoltan Urban, director at HypoVereinsbank in Budapest, notes that they had to consider the issue of having one big offtaker in a cyclical industry. ?For the lending banks, there was the question of industrial risk, and looking 15 years ahead at the chemical industry,? he says.

Most power stations borrow in a mix of forint and dollars or euros. ?In order to hedge their foreign currency exposure,

people borrow in a mix currencies, though a forint denominated loan could be as large as $350 million if every local bank participated,? says Berecz Csaba, managing partner at Linklaters, a leading project advisor to borrowers.

Csaba at Linklaters sees more deals getting done in Hungary during 2001, in spite of the uncertainties in the electricity market. ?I think there will be deals on the power side, the government is trying to renegotiate some of those contracts and there will probably be compensation on frozen costs,? he says.

Czech Republic and Slovakia

There is also currently a lot of M&A activity in the power sector in Slovakia, and buyers are likely to finance their acquisitions via project loans backed by PPAs. One recent deal involves the sale of PPC, which is a combined cycle plant guaranteed by Slovak Energy, which is a joint stock company owned by the government. Slovak Power was the offtaker.

?The government issued a guarantee which was a step meant to be for a limited period of time,? explains Ivan Cestr at law firm White & Case in Bratislava. ?US investors are bidding for a majority holding which will be project financed, and that will allow the government guarantee to be replaced,? says Cestr. ?The main driving force behind this deal is that the government wants its guarantee taken out.?

As in the Czech Republic, Slovakia has been increasing its total generation capacity with nuclear power plants, financed by Slovak Power, and more units are being added. ?They were short of electricity generation capacity before the first two units at Mokovsa came into operation, but not now,? says Cestr.

Elsewhere in the region, nuclear power continues to play an important role, since countries cannot afford the expensive option of running down their generators, and development banks are heavily involved in financings.

In October a preliminary contract was signed for completion of two Ukranian reactors. The final $500 million contract is scheduled to close in January, and involves Energoatom and a group of companies led by Framatome and Siemens. The EBRD is expected to be involved in this financing.

And earlier this year US Eximbank approved backing for a $77 million loan to support the involvement of Westinghouse in upgrading two 1,000MW Soviet era nuclear reactors in Bulgaria. The two units are known as Kozloduy Units 5 and 6, and with the help of new instrumentation and control equipment, radiation monitoring equipment and other safety features will be brought up to western design standards.