First and last?

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?Enron really is a merchant bank disguised as an energy company,? says Debra Hemsey, vice-president in the global energy and power group at Credit Suisse First Boston in New York. ?They really understand risk and credit.?

And it is this understanding of risk and credit which led the company to privately place $95 million of 10-year trust notes based on swaps taken out on various risks associated with three of its European power projects. In addition the deal involves $30 million of class A certificates and $15 million of class B certificates, both of which are subordinate to the trust notes.

The deal, which was rated by Standard & Poor's (BB-) and Duff & Phelps (BB), relates to three of Enron's European projects which have been financed on a non-recourse finance basis over the past four years ? Sarlux in Italy, Trakya Elektrik in Turkey and Nowa Sarzyna in Poland.

Enron wanted to extract money out of its projects based on its equity but at the same time transfer some of the risks. And when Enron approached Donaldson, Lufkin & Jenrette (DLJ), now part of Credit Suisse First Boston, in the third quarter of 1999 it was with the idea of carrying out a straight monetization of its European project portfolio.

But as the deal was progressing late in 1999, Enron hit a stumbling block and found it was unable to secure the full consents for the deal to go ahead from its partners in the three projects. At issue was the fact that a project portfolio monetization would require full public disclosure from all the parties involved in the three projects.

Enron could have gone down a more conventional corporate finance route but this would have required the company to provide some level of guarantee and would not have reduced its risk profile. ?So Enron asked us to come up with an alternative ? a way to get the money, transfer some of the risks in a way that wouldn't require too much disclosure,? says Hemsey. ?We had to get as much risk transfer within the constraints of disclosure.?

So DLJ set up the swap structure, which creates a wrap against a series of risk factors, most of which are external to the project. Says Hemsey: ?We had to look at the pure operational performance of the three plants and set benchmarks against which actual performance would be compared.? The risks vary for each project but include political risk, fuel price risk, fuel efficiency risk, inflation and the withdrawal of government subsidies.

Under the terms of the swap agreement, Enron North America, guaranteed by Enron, has entered into a swap agreement with Pelican Bidder ? a joint-venture company owned by Enron and Osprey Trust. Pelican owns part of Enron's stake in the three power projects and receives equity dividend payments from them. As part of the deal, Pelican makes a fixed semi-annual payment to Enron in return for floating payments ? the maximum payment for any one-year being $36.37 million. This maximum payment ?can be reduced by adjustings that are triggered by worse-than-expected technical performance of the projects as well as by non-project risks?, according to Standard & Poor's.

Notes are issued by European Power Company, the risk transfer vehicle, and reflect the risks associated with project-

adjusted swap payments that European Power is entitled to under a 12-year swap deal with Enron ? the counterparty.

Says Duff & Phelp's: ?In essence, the projected floating payments made by Enron under the swap agreement are a derivative of Enron's credit profile and provide substantial liquidity to the payment stream. Still, noteholders' exposure to floating aspects of the swap payment results in a weaker credit profile than Enron's senior unsecured credit rating.?

The swap payments are set up to reflect the dividend flows to Enron from its equity investments in the three plants. These swaps mirror pre-determined events, ones that are easily analysed by investors and ratings agencies. These risks are then passed on to the noteholders. All of the swap adjustments are cumulative with the exception of those related to a Turkish credit event. Swap payments depend on the occurrence of the risks within predetermined boundaries. Interest on the senior secured notes ranks ahead of payments of dividend to Class A and B equity certificates.

According to Standard & Poor's: ?The transaction's performance has been tested using a large number of sensitivity scenarios. These sensitivities, several of them severe, demonstrate the robust nature of the project. In all but the most severe combined downside case, the transaction is able to fully service the notes. In addition, the notes' principal and accrued interest will always ultimately be paid by the residual value of the swap in all but the most severe cases.?

The deal that emerged is essentially a virtual project portfolio, a synthetic structure using Enron derivatives. Noteholders are accepting risks that are common to most project finance deals. But surprisingly, breaking down the highly complex risk profile that is common to most non-recourse finance deals into a few key risks, proved difficult to swallow.

The deal, which was being outlined in January 2000, took until the middle of 2000 to finalise, longer than might have been expected when the deal was originally outlined. Hemsey says the time taken to carry out the transaction is typical of a landmark deal in which rating agencies and noteholders have to get up to speed on the ideas behind the new structure. ?When the market is forced to look at an analysis which it has never seen before, there has to be a lot of educating.?

Hemsey says: ?Really a lot of the performance criteria are based on normal project finance risks which investors take every day. Ironically by putting a spotlight on a few of the risks it can make it tougher for people to digest.?

After initial scepticism over the lack of information, key investors did buy into the transaction, albeit at a higher cost to the deal ? although financing details have not been released.

However, Hemsey believes that a variation of the structure could be applied again and for other issuers. ?It's a brilliant solution for any party with disclosure sensitivities,? says Hemsey. This is particular relevant for projects in countries where participating companies are not used to revealing key financial details. But even in countries where account practises are more open, companies may have other reasons for wanting to preserve project details.

In particular, in the US where companies are increasingly concerned about revealing competitively sensitive details of their transaction, but are eager to transfer as many risks as possible, the structure could prove useful. Although arguably in many cases companies are more likely to favour a cheaper financing structure ? the risk and reward ratio is still important.

However, the more risk that can be transferred the better the upside for the company. Hemsey notes, for example, that a future contract could have removed the gas supply risk had an agreement been negotiated with the gas supplier.