El Paso puts on the Cedar Brakes

01/10/2000

El Paso Energy (EPE) has issued a template $320 million securitization designed to free the energy conglomerate from the strictures of a power purchase agreement (PPA) at one of its cogen facilities. As fewer projects are financed and conceived on a standalone basis, and as sponsors attempt to make use of a large and diverse asset base, such a deal could have real potential in the transition to a merchant market. And it looks likely that US regulators will look favourably on a structure designed to lower rates paid by consumers and cut down on stranded cost exposure.

This is not the first time that EPE has made use of the structure, but this is the first time that the securitization has moved out of the private placement market and into the Rule 144A registration rights open market. It fits in with EPE's view of the inseparability of its generating and trading activities ? that both can complement each other. If all goes well up to half of its assets can be unencumbered in this way and El Paso can become an even more formidable presence in the US electricity market.

The focus of the deal is the PPA between the El Paso-controlled Newark Bay cogeneration plant and the local utility Public Service Electric & Gas (PSE&G), owned by global concern Public Service Enterprise Group. The PPA was one of a raft of agreements concluded in the late 1980s and early 90s that gave the independent power producers extremely generous terms. The market has changed, however.

It is not merely that the utilities face pressure to bring their rates down and to minimise stranded costs exposure (where these cannot be recovered). More importantly, and part of the reason for the renegotiation, is that power producers are drifting steadily from the view of their assets as standalone entities towards a more holistic conception of their electricity businesses. A company with a diverse asset base and a clued-up trading arm can exploit considerable arbitrage opportunities over the markets within its footprint.

The securitization is largely an add-on to the process of freeing up El Paso's asset, a useful way to mitigate some of the effects of lowering the rate that it offers to PSE&G. PSE&G is happy with the lower rate, and in return frees EPE from the requirement that the PPA is served by the Newark Bay facility. The producer's obligations can be met with power that it has bought in from a third party.

The deal works through a special purpose vehicle, Cedar Brakes, taking over the PPA between the Newark Bay Cogeneration plant, bought by EPE from PSEG and ENMEX in June 1999, and PSE&G, in its capacity as local utility. The purpose of the securitization is to pay for this purchase, with repayments of the notes coming from fixed capacity payments by PSE&G.

Cedar Brakes, the SPV, is jointly controlled by EPE, both through the company's own holding structure and the associated vehicle often used by El Paso, the Limestone Electron Trust, which dilutes EPE's nominal, although not effective, controlling interest. The structure is, however, not non-recourse. Investors have been asked to not only accept the continued credit quality of PSE&G, but also the ability of EPE to source its power obligations. Rather than try to turn the transaction into a merchant credit, EPE has guaranteed Cedar Brakes' part of the bargain with PSE&G.

EPE can source its power from which ever of its portfolio of assets represents the best value at any given time when the energy is required under the amended PPA. El Paso Merchant Energy, as a power marketing arm, should be poised to deliver substantial savings. It is this margin that represents the upside, if any, from the new transaction, although those close to the deal maintain that this remains secondary to the goal of operational flexibility. Given the volatility and risks that can be associated with power trading this will continue to be the case.

Newark Bay is located in the increasingly competitive PJM region. It is part of the US where EPE has considerable interests, but also one where overbuild is likely to bite first, bringing with it plunging prices, at which EPE can purchase its power requirements. PSE&G will not exploit any shifts in the market to the full, but may be able to lower its rates by a total of $74 million. El Paso, however, manages to increase its leverage to 100% and remove the operating risks associated with the asset. ?It mitigates risk without calling on the utility to write an upfront cheque, which is a good thing?, commented one source close to the transaction.

Moody's Investors service rated the issue Baa2, based on a PSE&G credit rating of Baa1, a $12.8 million liquidity reserve and other backstops. The notes were sold by Credit Suisse First Boston, with a maturity of February 2014 and a yield of 8.5%. They were priced at 261bp over treasuries, and although the deal was largely presented to the bookrunners as a finished package, CSFB made sure that the issue reached as many suitable investors as possible. Roadshows for the issue were an educative process, albeit one that tended to highlights the knowledge gaps amongst the investor base.

EPE is examining a further use of the structure on other properties in the region and throughout the US. The structure, however, does have several pre-requisites: most importantly a strong and amenable utility. Those that are a good enough credit to offer a certainty of timely repayment, but also those that have something to gain from a PPA renegotiation. Into the latter category fall those locked into older PPAs and those that have faced difficulty in recovering stranded costs. Regulators, unsurprisingly, have looked on benignly at the prospect of rate cuts at no cost to government or the utilities' balance sheets. El Paso estimates that around 50% of their recently-acquired facilities may fall into this category, although other producers will also be eyeing keenly the progress of the secondary market trading.