U-turn

01/08/2000

There are few lasting trends, it seems, in Australia's power market. Over the last 12 months the sector has seen a number of significant reversals highlighted by the cancellation of the Kogan Creek power project and a low buyer turn out for electricity asset sales in Victoria and South Australia.

A year ago the market was characterized by a plentiful supply of good quality power deals and a relatively thin bank market. The year 2000, in contrast, has so far seen an oversupply of debt (Japanese and European banks have returned in strength to Australia) and not enough deal flow to meet debt demand.

Several commentators have suggested that decisions by both TXU and National Power to finance their new assets (Optima and Synergen power plants in South Australia respectively) on balance sheet indicate the difficulties of doing power transactions in the current Australian project finance market.

In fact, the decisions owe more to the small volume of funds actually required; $175 million for Optima and about $21 million for Synergen, and to future ambitions in the international market than funding issues. ?As far as bank debt goes, it's a quite aggressive and hungry market even for unregulated power assets,? says Alister McConnell, head of Australian project and structured finance at National Australia Bank (NAB). Pricing for deals in the unregulated market is holding steady rather than continuing to rise, McConnell adds, while pricing for regulated assets continues to drop.

Another reverse, Queensland, the state where new greenfield cogeneration projects were most doable in 1999, has become a much harder nut to crack post the Millmerran financing, a development that the demise of the Kogan Creek deal clearly demonstrated.

The project, sponsored by Consolidated Electric Power Asia (CEPA), part of the Southern group, was to be a coal-fired 680MW baseload merchant power station to rival Millmerran. Financiers say the scheme was put in jeopardy partly because of the Queensland government's desire to push for more environmentally-friendly, gas-fired power stations.

But financing issues were also responsible for the cancellation, indicating that if merchant power deals in Queensland are still possible to finance, the process, here at least, has become increasingly difficult. The successful, prior launch of Millmerran significantly altered the outlook for electricity demand and supply adding to the political and environmental difficulties that Kogan Creek faced. Even before Southern pulled the deal, WestPac, which had originally lined up as one of the arranging banks, withdrew from the transaction. ?This was because,? says one financier, ?the institution was struggling with the credit profile of the merchant power deal.?

Kogan Creek's other arrangers, Bank of Tokyo-Mitsubishi, Barclays, Citibank and Deutsche did get to within a hair's breadth of launching a general syndication and say the deal was generating a favourable pre-syndication response. ? There was certainly strong interest from sub underwriters,? says one of the lead banks. However, financiers had to extract heavy concessions from Southern in the financing terms before they were satisfied that the deal would work. According to the documentation terms, Southern would have had to guarantee a minimum floor for the electricity price for the first five years, a feature of the financing that Southern's board was ultimately not prepared to sanction.

The latest Queensland power station deal, a A$600 million ($350 million) financing to fund Intergen's purchase of 50% of the 840MW plant at Callide, looks set to tap better terms and pricing than the Millmerran deal (and far better terms and pricing than Kogan Creek). The transaction demonstrates how important Queensland's electricity demand and supply outlook has been in determining the banking community's response.

Richard McIndoe, vice-president of finance at Intergen's Hong Kong office notes that the Callide deal is a second financing for the power station, taking out a portion of the original financial package. Shell, which is selling its stake in Callide to Intergen as part of the overall disposal of Shell Coal, started building the power station in 1998, in tandem with CS Energy ? the two sponsors had the original funding for the project in place several years ago. Since the Intergen financing does not therefore revolve around adding new capacity to the Queensland market, financiers have been able to use supply and demand analysis and pool price profiles which were very similar to those used in the Millmerran fundraising.

Three banks ? Bank of America, BNP Australia and National Australia Bank ? are arranging the facility which will include a A$300 million non-recourse tranche and a combined equity and bridge finance facility backed by Intergen's shareholders, Shell and Bechtel. ?The deal will feature a limited and reasonably straightforward syndication,? says NAB's McConnell.

The Callide deal is due to close as Project Finance goes to press. But post Callide there will be relatively few large merchant deals to test the market during the next 12 months. Basslink, the A$500 million interconnector which will link the electricity transmission networks of Tasmania and Victoria won't be in the finance market for at least a year, say bankers, because of its 2001 construction schedule and the multitude of legislative and environmental issues that need to be resolved first. By the time it is financed, Basslink will be an interesting update on bank appetite for merchant risk. Glenda McLoughlin at Barclays Capital says the Basslink scheme exhibits more merchant attributes than rival interconnectors like the 1000MW QNI link, owing to the different way in which electricity passing through Basslink will be traded into the electricity market.

Equity interest dissipating

Not surprisingly debt markets continue to favour regulated projects ahead of unregulated alternatives. In 1999, equity investors were of the same mind. But over the last eight months, equity's traditionally strong preference for regulated assets has been diluted in favour of the unregulated market in Australia. Moreover, whether its a regulated or unregulated power industry investment, there is far less equity interest in the Australian market generally than there was two years ago.

The most compelling explanation for the dwindling interest in Australian power assets is the fact that international power companies, particularly in the US and Europe, are shifting the focus of their investment strategies back into their home markets at the expense of Asian investment opportunities, says McLoughlin. Having seen their share prices plummet as investors switched into high tech investment plays, power utilities have been increasingly attentive of stock analyst comments, including criticisms of overseas spending policies. McLoughlin says, ?the imperative for power companies to be bigger and for the industry to consolidate is still there, but this consolidation drive is strongest in the US and Europe. As far as most western power companies are concerned, Asia, Australasia included, is now off the map.?

An unpredictable regulatory environment in Australia has helped to turn what was once an influx of foreign equity into an exodus. Electricity companies that originally invested in Victoria's energy assets complain they have been misled by a state government that they believed would maintain a benign regulatory policy. Instead, in June, the Victorian Office of the Regulator General handed down its draft determination on electricity prices for the distribution sector, a determination which effectively striped power companies of the efficiency gains achieved in the first five years of private ownership and handed them down to the consumers.

In similar fashion, Ian Grayburn at Commonwealth Bank of Australia's project finance team, says that the tax arbitrage that equity investors previously enjoyed when buying into power assets in Australia is no longer there, thanks to another regulatory change two months ago. Up until then, investment regulations allowed players in the power market a more generous return on investment under the assumption that the owners were tax payers. In actuality, because of the high tax deductions for interest expenses and depreciation, investors have tended not to pay tax until well into the life of the investment.

Capping the list of reasons for the declining attractiveness of the Australian market, assumptions that were made about the privatized energy industry being extended to Queensland and New South Wales have proved ill-founded. Since the privatized energy market remains small and predominantly focused on Victoria and South Australia, the rational for international firms to get into Australia is that much less convincing.

It was these concerns that smothered most of the potential interest in GPU's recent sale of PowerNet Transmission in Victoria. The PowerNet sell-off, led by Deutsche Bank, was originally conducted as an open, competitive bid. But expressions of interest were disappointing and did not meet GPU's initial expectations. Under pressure from shareholders to cut debt levels and boost the share price, GPU's board was finally force to sell to Singapore Power in late June, for a loss of A$450 million.

Equity interest has not picked up since then. Whereas Cheung Kong Infrastructure's (CKI) participation did make the first round of bidding for PowerNet a two horse race, Singapore Power is thought to be the only interested buyer in Scottish Power's sale of Victorian electricity distribution company, Powercor. Bids for the asset were due in at the end of July.

The two other major energy asset sales taking place in the next few months are the sale of CMS Energy's 49.8% interest in Loy Yang A power station (and with it a portion of Loy Yang A's A$3.5 billion in senior and subordinated debt) and, secondly, the privatization of ElectraNet, the high voltage transmission business in South Australia with a book value of about A$650 million.

A banking source involved in both sales describes the field of contenders as ?focused,? ? undoubtedly a euphemism for small. And the source continues, ?in this sort of environment, if you get two to three submissions of interest you feel pretty good.?

The ubiquitous Singapore Power is known to be interested in the ElectraNet sale. National Grid another potential contender, is thought not to be. ?National Grid looked once at the PowerNet sale but wasn't interested in progressing. Since PowerNet is a bigger asset than ElectraNet you have to assume National Grid won't be interested in ElectraNet either,? says one banker. Other interested parties are thought to be CKI and Hong Kong Electric. ?ElectraNet does at least fit the sorts of assets that the two Hong Kong companies have been targeting over the last twelve months,? the source says.

Ironically, electricity companies in the Victorian market (power producers at least) are facing a brighter electricity price outlook now than when the privatization process first kindled the interest of power players around the world.

Hedge prices, rather than spot prices which are extremely difficult to predict several years into the future, give the best indication of where prices will be four to five years down the road. Current hedge prices are a source of encouragement. According to Mark Schneider, energy market Associate Director Project and Structured Finance at NAB, electricity prices are at about A$35 a megawatt hour for hedges five years out and are likely to move slightly higher. ?During the first few years after deregulation in Victoria, hedge prices were significantly lower,? says Schneider.

With these improved fundamentals, the hefty loss that GPU suffered in the PowerNet sale may not be repeated when

Loy Yang A is sold. Analysts also believe that Scottish Power will at least achieve break-even in the Powercor disposal.

If equity investors have been tentative about the Victorian energy market, bankers have been less so. The debt financing of Singapore Power's acquisition of PowerNet proceeded without any major hiccups. The total A$2.1 billion acquisition has been financed, says Michael Cleery at WestPac, by A$1.625 billion of senior debt, recourse to PowerNet (but not Singapore Power), and by A$475 million in equity. The banking market reacted positively to the deal partly because the deal was more conservative than GPU's original financing. The reduced price tag meant a lower debt burden than the A$1.9 billion which GPU had had to shoulder. Singapore Power was also able to bring a stronger credit rating to the table, (A+), compared to GPU's A rating.

McLoughlin thinks there is a good chance that the acquisitions of both ElectraNet and the Powercor acquisition will be part financed in the bond markets, following in the footsteps of the ETSA (Electricity Trust of South Australia) privatization.

Even Loy Yang A, a different kettle of fish to a monopoly type transmission business such as PowerNet, will find favour in today's bank market. ?The other Victorian assets are not unbankable ? after all we are talking in the case of the generation facilities about baseload power stations, strategic assets for the economy,? says Grayburn.