

AES Red Oak- US Bonds Kick Off

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The \$384 million bond financing of the AES Red Oak power plant closed on March 15 – one of the first bond issues this year in the US power market. The deal builds upon the Ironwood financing also completed by AES last June. Both deals stand out in the current US climate, if only because these single-asset transactions are likely to be dwarfed by the anticipated capital markets take-outs of recent genco financings.

AES is an 830MW combined-cycle natural gas-fired generating station located in Sayreville, New Jersey. The plant has good access to the Transco gas pipeline, located in a deregulated access, as well as other regional pipelines. It also has a direct transmission link to Jersey Central Power and Light, a GPU utility subsidiary.

Ironwood was the first capital markets financing to use a power marketer as sole off-taker rather than a utility. Red Oak has a similar structure in place, with Williams Energy Marketing and Trading entering into a tolling contract for 20 years. Williams also acts as fuel suppliers for the first part of the plant's life. However, for Ironwood the entire \$308.5 million issue came with a five-year uncontracted tail, whereas Red Oak comes readily dressed up for the discerning bond investor.

The deal has been led by Lehman Brothers (which also led on Ironwood) and co-managed by Dresdner Kleinwort Benson. With Red Oak, however, the issue was split into two tranches to more adequately reflect the different levels of risk with the project. The paring off of merchant risk from non-merchant risk gives a strong signal as to the limits of US appetite for the former.

AES is normally far more comfortable with contracted off-take agreements, in marked contrast to the prevailing merchant mania in the US. Indeed it is likely that after the end of the agreement AES would go and look for a new partner, although this cannot be factored into the financing structure or the ratings process.

The majority of the bonds, some \$224 million, are due in 2019 and are 100% covered by the Williams tolling agreement. As John Veech, vice-president in Global Project Finance at Lehmans says, "the base business plan is to extend the tolling agreement, but 20 years is pretty much a pricing point anyway". The short tranche has a 14-year average life and has been designed to appeal to investors wary about further merchant exposure.

The 20-year tranche has effectively been treated as a Williams derivative credit, and uses Williams expertise in energy marketing, a function that it also fulfils for some of AES' Californian assets. Charles Falter, project director for Red Oak says, "now, and especially after Ironwood, they [investors] view it as very much like the utility power purchase agreements of a few years ago. In a market dominated by merchant plants, that's a plus". In this case Williams shoulders the risks involved with potential price volatility in the New England market and the possibility of rises in gas prices.

The second 30-year tranche is only around 40-44% covered by the agreement, although Veech notes that coverages in the back end are high. Whilst bullish about the continued level of comfort for merchant risk, Veech acknowledges that the structure made it easier to pick up investors still more used to contracted deals. From AES' point of view it was simply

a question of maximising the economics ? only being prepared to pay the higher spreads for clearly defined risks.

The issue was priced on March 10 and closed on Wednesday March 15. Veech says that whilst spreads on Triple-B corporates widened by up to 50bp during the week, he managed to keep the Red Oak spreads together. Certainly the deal was familiar from the earlier Ironwood transaction with market sentiment described by Veech as ?pretty favourable?.

The US project bond market has been relatively slow taking off this year, and investors have been seemingly holding back until the end of the quarter. The ease with which Red Oak, with only the NRG issue in the same market, was sold contrasts sharply with Ironwood, which came out at the end of a slew of similar issues in the US. As Veech puts it, ?this year you're going to see a lot of new product out there, so being first in the pipeline definitely helped?.

Nevertheless, the difficulties of operating in the relatively mature mid-Atlantic market are obstacles that Red Oak and Williams will need to overcome. The Pennsylvania-New Jersey-Maryland area already has a surfeit of low cost coal and nuclear base-load capacity. The worry is that this capacity will be dispatched before Williams can do likewise for AES Red Oak. Falter points out, however, not only that the plant's dispatch order is relatively high, but also that new capacity will be required in the region as early as 2002. Certainly, New York was on the receiving end of some supply stresses last year and continued industrial growth should provide a booming market.

Moreover, to receive the necessary payments under the tolling agreements, essentially a modified PPA, the plant must reach stringent availability targets. The turbines used by Red Oak, the Westinghouse 501FD, whilst efficient, are some of the less proven technology used in the industry. Falter is confident that the technology is proven, and moreover provides the best possible operational fit: ?The F technology has been there since 1993, and we're quite comfortable with it. There were a few glitches, but they've been sorted now?

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