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01/11/1999

Bank hunger for high quality power projects in the US is ravenous - as was demonstrated by the recent closing of financing for the 1,000MW gas-fired facility in Guadalupe County, Texas.

Lead arranger ING Barings took only 10 weeks to put in place the $312 million worth of senior bank debt, which was fully underwritten and funded in mid-October with the help of co-arrangers and co-agents WestLB, Bank of Nova Scotia, Union Bank of California, CoBank, HypoVereinsbank, MeesPierson and Dai-Ichi Kangyo Bank. Retail syndication is now underway.

One of the notable aspects of the Guadalupe transaction is the fact that the plant is 100% merchant, with no underlying long term power sales agreements. But banks were able to take comfort from the 40% equity provided by sponsors Texas Independent Energy (TIE), which is a 50:50 joint venture between Panda Energy International of Dallas and PSEG Global of New Jersey.

The same sponsors are now busy working on another 1,000MW gas fired facility being built near Odessa in Texas, and the mandate will soon be awarded to arrange bank financing for this deal.

"The market has received the financing that ING has packaged very well, which is quite gratifying given that Guadalupe is a fully merchant plant," comments Tom Smith, president of PSEG Americas. "The fact that there are no power contracts whatsoever makes this deal very notable. We have a program for power disposition, and at the appropriate time it is our desire to include some contract sales in a combination with spot sales, but as of now there are no contracts at all."

Smith was also happy with the level of equity that the sponsors needed to put up. "I would have to characterise 40 % equity as somewhat low for a fully merchant facility, and that was achieved because of the good project fundamentals," he argues. "We were very pleased with a 60:40 capital structure, and not something like 50:50 or even 40:60."

In the current project finance market an increasing number of projects are being financed via capital markets transactions, but from the outset the Guadalupe sponsors assumed that it would be financed with bank debt, with the probability of a future capital markets takeout.

"We always felt we would go to the bank market first, because we did not think that for a fully merchant facility in construction we could get an investment grade rating for a bond sale, and we did not feel that we wanted to issue high yield bonds," Smith explains. "Rather, we felt that we could get attractive bank financing, and then with this power plant, in conjunction with other assets that we are pursuing in Texas, we could go out at a later date and present that to Moody's or Standard & Poor's and get an investment grade rating down the road for a portfolio of projects."

With regard to the awarding of the mandate to arrange the loan finance, PSEG had a good relationship with ING, having worked together on a number of projects in South America, where PSEG Global is very active. It owns, operates and develops private power and distribution facilities across the region, and has close to 40 projects under construction or already on-line in countries such as Argentina, Brazil, Chile, Peru and Venezuela. Panda Energy is a long established company which has pioneered the development of clean, low cost power generation, and is active both across the US and Asia.

"We had a pretty tight schedule, because the sponsors have other initiatives going on in Texas," says Smith. "The original target was nine weeks, and they made it in 10, so we were very pleased with their ability to execute."

Brian Urban, vice-president for project finance at Panda Energy International was also pleased with how rapidly the financing was put together, especially since TIE has another project to finance in the near future. "It demonstrates that Guadalupe is a quality project," he says, and TIE also hopes to see strong bank appetite for its upcoming financing. "The next project in Texas is the Odessa project, which we would hope to finance within the next three to four months," he adds.

With bank financing in place for both of these, more assets may be added to the group in Texas, and a likely future capital markets takeout would probably involve a number of assets, and not just Guadalupe and Odessa.

Both of these are combined cycle facilities, and there is some overlap in markets which they will serve, and thus it might make sense to add other types of generating assets, with different cost structures. This could be done via acquisition of existing assets, and TIE is a possible buyer for some of the assets currently being disposed of by Texas Utilities.

This strategy reflects a commonly held view within the US power market that the players who are going to make money will be the large developers with a well diversified portfolio of projects.

Smaller developers with only a small number of assets are going to find it more difficult to raise financing, so the theory goes. Thus some of the smaller private power developers who have become active as a result of the deregulation of the US power market are going to face tough market conditions, particularly in California, Texas and the north-east, where most of the building is taking place. "We will probably look to add other different types of generating resources into Texas Independent Energy, and when these projects get more advanced in the project cycle we will then consider, along with the other things that may be in our joint venture, going and trying to get an investment grade rating for a capital markets takeout at that time," explains Smith at PSEG.

At that point there may also be further refinements made to the financing structure, such putting a lease on top, though this was not considered during the recent bank market financing, as the aim was to move ahead as quickly as possible with a relatively straightforward bank loan structure.

"We have used leveraged lease structures on other deals," says Urban at Panda Energy, such as the Brandy Wine project in Maryland. "There are some fairly interesting structures out there, and that is certainly something that we will take a look at, though it does add some complexity," he says.

"The benefits of a leveraged lease are desirable, but on the other hand a lease does complicate the structure," agrees David Barrick, managing director in the project finance group at ING Barings in New York. "Including a lease may not only mean taking longer to close, but in syndication you may lose the participation of some banks who find it just too complicated."

But as it stood the financing for Guadalupe was undoubtedly very attracive to project finance lenders. "Appetite has been very strong," says Barrick. "We actually closed with five banks having come into the transaction, which is different to the way we often handle transactions at ING. In those cases we sole underwrite, close, then syndicate, but there was a great deal of interest and we were able to bring in five banks before closing. We are now in retail syndication and things seem to be going well there."

The debt financing involves a two year construction loan, converting into a five year term loan, and was priced at Libor-plus 150bp for the construction period and first three years of term, subsequently stepping up to 175bp for years six and seven.

One issue which lenders had to address when assessing the prospects for Guadalupe was the large number of new power projects which are expected to come onstream in the Texas power market, and how this may impact electricity prices in the coming years. Guadalupe will be online by December 2000, but many other power plants are also springing up and connecting into the Energy Reliability Council of Texas (ERCOT) grid.

"We at PSEG believe that the Texas market is going to be overbuilt," says Smith. "There is a tremendous construction and development program taking place within the ERCOT market, and the market will over-respond to the build signal which is currently so powerful in Texas."

"At some point the banks will put the brakes on," he says. "We are not there yet but we are getting there pretty quickly, so the idea is to get our good quality projects up and running, and the fundamentals of these projects will enable us to withstand the overbuild storm."

The lending banks have of course run their own models which take into account a significant amount of new capacity being added into the ERCOT market. With regard to Guadalupe, in addition to the 40% equity cushion below the bank debt, ING has built into the credit structure a number of mechanisms such as cash sweeps which, if overbuilding does occur, provide some sort of correcting mechanism. If there is serious overbuilding in Texas, then the loan coverage ratios will suffer, will trigger the cash sweeps, prepay some of the debt, and so bring the coverage back up.

And these mechanisms help in other ways too. "Cash sweeps are usually based on coverage ratios, and not on a specific risk such as overbuilding, so a secondary benefit is that they mitigate against other risks such as poor plant performance or interest rate hikes which would also lower coverage ratios and trigger the cash sweeps," explains Barrick at ING. "So in a way the cash sweeps offer protection against some of the traditional risks that project lenders have to think about."

In any case Urban at Panda Energy points out that not all the announced power projects will actually get built, and argues that the market should be able to absorb most of the new capacity being added. "There is certainly a lot of interest in new power projects inTexas, but the growth rate of Texas power requirements has been very high, and demand for power remains very strong," he says.