Cross-dressing

01/11/1999

$10 billion worth of financing this year alone and rising: "The pace of financing for the power industry in the US in the past few years has been breath-taking," says John Veech, senior vice-president in the global project finance department at Lehman Brothers in New York. With that rush, fuelled largely by deregulation, US power market financial engineering has become as corporate credit driven as it is asset driven, and broadened its use of financial instruments. Sponsors such as Calpine, Edison Mission Energy, Southern Energy and PG&E are not looking at pure project finance but a total financing solution - maximum financial engineering for a maximum return on assets.

Some banks are responding. Hybrid project financings combining leasing, project bonds and straight debt are becoming the US norm. And as more business comes to market the banks are having to follow the sponsors down the off-balance sheet path to bolster capacity for more deals. Since January there have been at least seven US power deals in the bond market and eight financed in the bank market. And these are not small transactions.

At the end of October, for example, Southern Energy secured $1.45 billion in financing for 7,350MW of its merchant assets. The package includes power plants from four separate auctions for projects in California, Boston, New York, Chicago, Texas and Wisconsin. Lehman Brothers lead arranged financing for the deal together with Commerzbank, Bank of America, Scotia Bank, ING Barings and Dresdner Kleinwort Benson. The financing package takes the form of a 364-day bridge loan with a two-year term out and a five-year working capital facility. This gives Southern the option to return to the bond market to refinance at a later date and gives it time to assess the best time to launch.

According to Gary Kubik, executive director of finance at Southern Energy, the "strategy is to reap the benefits of the large diversified national generation portfolio. Over the past two years Southern had acquired (or was in the process of developing) over $2 billion of diversified assets. By pooling the assets, we maximized both the overall value and the operational flexibility of the portfolio and minimized debt transaction costs."

"The Southern deal marks the next step in the evolution of the power sector in the US," says Veech. "We have gone from a project finance way of thinking to a corporate finance approach."

This semi-permanent financing structure for Southern is typical of what has been happening in the bank market in the past year, where the effects of big-ticket bank mergers, combined with the Asian crash, have slashed overall balance sheet capacity. "Commercial banks have become more like investment banks in some cases," says Veech. "They are not asset gatherers anymore. They want their fees and then they want to recycle that deal as quickly as possible." In effect - the banks have joined the sponsors in the off-balance sheet race and are trying to find ways to free up their balance sheets to keep pace with the next wave of deals.

Credit Suisse First Boston (CSFB) took the first step towards relieving its balance sheet last year when it issued the first collateralized bond obligation for a portfolio of its project finance deals. Most of the deals included in the $617 million package are US power which have completed construction, although one Latin mining deal has also been thrown into the pot. The response from institutional investors was positive and CSFB has since been working on the follow-up deal with a bag of more complex transactions from its global portfolio.

Jonathan Cohen, assistant vice-president and analyst in the corporate finance power group at Moody's in New York, predicts that similar deals will emerge in the next year as other banks try to unload their heavily burdened balance sheets.

The hybrid deal emerges

But Cohen also points to another trend. Traditional project finance - the pure non-recourse finance deal which assesses basic principles such as secure power-purchase agreements - is being consigned to history in first-tier markets. In its place is the hybrid deal which incorporates, for example, merchant risk, a bridge loan which flips into a bond deal, or a lease structure.

Over a year ago bankers such as Jacob Worenklein, global head of project finance at Societe Generale (SG), were pushing for added-value project finance. It has arrived. Deals are no longer just pure non-recourse but involve elements of corporate finance. Banks might look to gain some tax efficiencies or additional off-balance sheet structuring into the deal by working in a lease or synthetic lease structure.

In the next month at least one more project leasing transaction will come to market and another will follow soon after. PG&E, the parent company behind the US Gen Lake Road financing, which closed at the beginning of September, have another 10 power deals waiting to be financed over the next 10 years. These include projects on the East Coast, in New York, Pennsylvania and the mid-west.

Beth West, vice-president in the project finance department at SG in New York, worked on the 792MW Lake Road financing. SG acted as co-lead arranger, with Citibank as lead arranger and Deutsche as co-arranger. The $460 million deal blends project financing with a synthetic lease structure (off-balance sheet loan). "PG&E wanted a structure that would enhance their earnings which is why we thought of using the synthetic lease," says West. "For tax purposes it is not a lease, for accounting purposes it is a lease." Pricing on the deal starts at 125 basis points (bp) over Libor rising to 225bp in stages.

West says that a number other earnings sensitive sponsors have already been attracted to this type of structure. Officials at PG&E were so impressed with it that they have already mandated Citibank, SG and Deutsche to arrange financing for its 1,000MW Paloma plant in California. The $750 million project will also use a synthetic lease structure.

Specialist boutiques are cashing in on the move towards lease structures. Lake Road is the first lease used for a greenfield US power plant. And other sponsors are moving beyond the synthetic structure into the tax lease market. At the end of May, Newcourt Capital closed a $247 million innovative leveraged lease financing for Calpine's acquisition of 14 geothermal power plants in California. Newcourt provided $38 million of lease equity in a $209 million, 24-year leveraged leased. According to Guy Piazza, director at Newcourt Capital, Calpine was attracted by the better accounting and tax profile of the deal and by the fact that the deal is not front-end loaded.

"This type of deal allows sponsors to maximize their income in the early years," says Piazza. Newcourt is already working on a further 48-year lease where debt is kicked out after 22 years and the ongoing strategy is simple: form partnerships with energy suppliers and juggle debt and equity roles to achieve the optimum accounting and tax benefits.

But the benefits from maximizing the tax profile of a deal can be offset by the added time and structural complexity. PSEG and Panda have a joint-venture partnership to finance assets in Texas. ING is lead arranging financing for the construction of one of three planned plants, the 1,000MW power plant in Guadelupe, Texas. The project is one of the few greenfields left in the market and has been financed through a relatively simple bank structure to ensure it closes with no hitches.

Accepting merchant risk

In addition to a new wave of financial engineering, financiers are waiting for the next generation of power projects in the US. The evolution of types of plant being financed has already been rapid. In the past year, financiers have moved from financing peaking plants with a set power-purchase agreement, to plants such as Kinkaid which carried some merchant risk, to portfolio deals such as the US Gen New England financing which involved a portfolio of hydro and coal-fired quasi-merchant power plants.

The next wave of projects will be more difficult to structure. Not all power plants can provide for peak capacity, some will have to supply base-load demand. This presents lenders with a new risk profile. Says Veech: "Whereas, lenders once had to assess a plant which operated 90% of the time and only operated on base load for 10% of the time, now lenders are having to address a situation where plants only operate at peak 20% of the time. It is the first time that lenders have had to evaluate not just commercial price risk but volume and price risk. Bankers are now zeroing in on how to ascribe value to this sort of asset."

Eric Silverman, global head of project finance at law firm Milbank Tweed Hadley & McCloy in New York says: "Banks and rating agencies have a fair degree of conservatism when it comes to future price levels of electricity. And this has a big impact on how a sponsor finances a given project. It means that sponsors are required to give more support and it means less leverage than in previous years."

Fluctuating price levels have been to blame for this uncertainty. Price spikes in the hot summer of 1998 meant that electricity became a scarce commodity and some corporates made huge windfalls. However, with thousands of megawatts of new capacity planned in the next few years, not every company will be able to sell its power. A glance at the UK and Australian markets shows that prices usually fall rapidly after an initial high. And that is what financiers fear.

Silverman sees an interesting tension being set up. "On the one hand you have the developers who are very bullish and optimistic. On the other you have the financiers who take a more conservative view." It is such scepticism which may have prompted the French company Vivendi to sell its independent power project arm.

Despite the exit of Vivendi and some of the largest utilities, US power companies continue to chase new assets. Calpine, for example, approached CSFB and Bank of Nova Scotia earlier this year to arrange $1 billion of financing for its construction programme. CIBC World Markets and TD Securities are co-arrangers. According to Robert Kelly, senior vice-president of finance for Calpine: "The construction facility will allow us to continue to roll out our successful development programme of building a portfolio of competitively-priced power generation facilities throughout the US." The facility has a four-year tenor after which will be refinanced in the capital markets.

With any slowdown in the US power acquisitions and newbuild markets a long way off, more project finance hybrids are set to emerge. And they will not be one-offs. Citibank, Deutsche and SG's involvement in the Lake Road financing, for example, is proof that a good template on one deal can lead to a string of other deals with the same sponsor.

The message from US sponsors is clear - more benefit, more flexibility, more innovation equals repeat deals.