Powerful twist of fate

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AES' 705 MW Ironwood project has a long-term power purchase-type tolling agreement that is reminiscent of times when the US power industry was regulated but, loaded with new twists, the greenfield facility successfully financed in a challenging US energy market.

The $308.5 million financing for AES Ironwood led by Lehman Brother at the end of June was the first deal completed in the capital markets with a power marketer as the sole offtaker, as opposed to a regulated utility ? LS Power's Bateville deal was two thirds utility and one third power marketer. Under the agreement, all of Ironwood's capacity, associated energy and ancillary services will be sold under a 20-year tolling agreement with Williams Energy Marketing & Trading. Williams will provide fuel to the project, which will be owned by AES.

Says John Veech, vice president of project finance at Lehman Bros. in New York. "Everyone was quite pleased with how the transaction got executed in a challenging market. The way that AES works, is that each project team, almost functions as a mini-AES and each project is looked on a stand alone basis, and on its own merits, both as to development, and financing. By and large, investors looked at the deals differently, because they were different transactions. By far the bigger challenge was the fact that we were marketing during a quarter in which close to $4 billion of capital markets project finance deals were done, approx. $3 billion in the project sector, coupled with some volatile events occurring on a macro level."

Veech adds: "What we were most happy about was the very large number of first time project finance buyers, particularly the large number of smaller and medium sized insurance companies and money managers, so we really made some strides in broadening the investor base."

In the weeks before Ironwood's financing, many bankers had complained that the $550 million AES Eastern transaction led by Morgan Stanley Dean Witter had poisoned the capital markets for project financed power deals bar none. Investors in AES Eastern largely discounted the BBB- rating given to the project by Standard & Poor's in favour of Moody's Ba1 rating. The $268 million tranche of the project's bonds are due 2028 and are priced at 375 basis points to US Treasuries.

Edison Mission Energy's 1,884MW Homer City project managed to finance $830 million in Rule 144A bonds several weeks later. But Ironwood project participants continued to fret. Says Veech: "Risk was addressed by spending substantial time in the road show, going through the strategic rationale of the deal with Williams, both for Lehman's fixed income research and for the rating agencies." He adds that investors need to understand why Ironwood's a "win-win" situation for all parties.

Mike Barr, a lawyer at Hunton & Williams in Washington DC highlights the contractual benefits in the Ironwood deal. "It has a contract that is essentially an investment grade contract and it always has the right if, for some reason, that contract is terminated to sell into the market, which according to the forecast looks like a strong one from the owners standpoint," he says. "There just aren't that many long-term offtake contracts like that that you can get into where you have state of the art, highly efficient, combined-cycle gas turbines. It is difficult to find a company that really knows how to organize the development process and to operate the unit and then somebody who is very knowledgeable about the fuel market and the power market who are willing to enter into a longer-term agreement. You really get terrific efficiencies, which is what happened here and will be repeated in at least a few additional projects like this."

Veech echoes Barr, commenting that there will be many more deals with power marketers in the future, as this is the way the business is developing.

At Williams Company in Tulsa, Philip Scalzo, vice-president of gas and power origination is counting on it. "This kind of arrangement allows both of us to do what we do well," says Scalzo. "Williams are premier owners and operators of power and we fashion ourselves to be premier fuel suppliers and power marketers." "This kind of arrangement allows both of us to do what we do well," submits Scalzo. "AES is a premier owner and operator of power and we fashion ourselves to be premier fuel suppliers and good at power purchase agreements."

Eileen Cates, a project developer at AES in Arlington agrees. "Having a 20-year power purchase agreement is fantastic when you're heading into a financing," says Cates, explaining that the agreement is among an increasing number of power project finance hybrids where a portion of electricity has an offtaker, along with a period of merchant opportunities.

Patricia Rollins, another project developer at AES notes that investors had a lot of questions at the road show about why the company entered into an agreement with Williams. Rollins stresses that Williams is attractive to AES because it is a well-known company with an overall strategy to build their power marketing operations. She noted the high profile nature of the Ironwood deal increases the desire of Williams to succeed.

Says Rollins: "We did do an independent assessment of pricing and we did feel and we told the investment community that we think it's a good deal for Williams because the pricing is at a discount to projected prices and it's a good deal for us. We're willing to take that discount in pricing because it gives us certainty of revenue, and that was a very key part of our presentation to investors and a very key reason for us to enter into an agreement like this with Williams."

An additional concern centres on Ironwood's use of new 501G combine-cycle gas turbines from EPC contractor, Siemens Westinghouse Power. While the turbines are scheduled to go into commercial operation at a facility in Lakewood, among other places, they do not have an operating history.

Says Rollins: "We felt that we were successful in addressing the technology issue and working with SiemensWestinghouse to work with the rating agencies and understand how this was evolutionary step on technology and not a revolutionary step."