Not just merchant

01/07/1999

In December 1998, Project Finance published a For & Against on the merits of a power-purchase agreement versus merchant contracts. Cordell Hull, the chairman of the World Council for Infrastructure Development said that during the next 10 years, the long-term power-purchase agreements would still exist as the basis for some considerable portion of power financing, even with the movement towards merchant power. And considering the size of the East Coast Power deal in the US, which carries no merchant risk, he was right.

?One of the things that make East Coast Power interesting is that it's probably one of the last contract-based transactions,? says Michael Hinds, director of project finance at Bank of America in Charlotte. ?Other transactions have been predominantly merchant. People are more confident with merchant risk, but there are lots of uncertainties.?

The deal has come to the market with a bond offering of $850 million, which quickly followed the signing of an $856 bridge loan for Enron's acquisition of three power plants, for which Enron paid $1.1 billion. The bridge loan consists of a $726 million non-recourse tranche and a $130 million bridge with recourse to East Coast Power. The first tranche is priced at 125 basis points over Libor and the second tranche at 25bp.

The $850 million bond offering quickly followed the closure of the bridge loan. Bank of America is bookrunner, Lehman Brothers and Credit Suisse First Boston are lead managers. SG is co-manager. Says Hinds: ?The deal is very aggressive and ambitious.? It was put together ?when the markets were in disarray?.

All three power plants included in the financing have long-term power-purchase agreements (see box) and this has led Duff & Phelps Credit Rating to consider cash flows for these projects adequate to a BBB- rating category. The rating agency has also valued positively the project's group of offtakers. Although Duff & Phelps does not rate Consolidated Edison, the offtaker for the Linden plant, it has assigned a shadow credit rating to the project's senior unsecured debt of AA-, which incorporates the expectation that Consolidated Edison will maintain its strong credit quality during the transition to open competition in New York.

For the offtaker of the Camden plant, PSE&G, the credit rating is also solid and the senior secured debt for this tranche is rated A. Rating issues, as assessed by Duff & Phelps, include nuclear exposure with the Salem and Open Creek nuclear plants. The agency took into consideration the fact that higher competitive pressures may lead to pricing pressure. This is due to a regulation signed in February 1999, establishing a four-year transition period with no rate caps for all customers choosing to remain with PSE&G.

Says Cheryl Lipshutz, vice-president of Enron Capital Management in Houston: ?We had a lot of regulatory issues which needed to be due diligenced.? For example, Enron cannot own more than 50% of any qualifying facility ? under the New York and New Jersey regulations ? and the three power plants are all qualifying facilities. ?But the regulatory risk issue is fairly well documented in both states,? says Hinds.

Another interesting feature of this part of the deal is that $2.5 billion of stranded costs and transaction costs will be securitized. Jersey Central Power & Light's senior secured debt rating is set by Duff & Phelps at BBB+.

An interesting challenge

Enron knew that the Cogen Technolo-gies plants were on sale for a while. It initially approached Cogen in mid-1998, which wanted to sell its plants on an IPO basis. Says Lipshutz: ?But then capital markets and equity markets began falling apart.? Enron then decided to approach Cogen again, confirming its interest in the acquisition but asking whether ?they were married to their IPO strategy?. A first tentative agreement was put together in October 1998 but then there was still ?a significant amount of due diligence to be done,? says Lipshutz.

Lipshutz says that there have been challenges. The project had to be insulated from tax leakage, as all three plants are owned by limited partnerships. But a good arrangement on the tax level was finally achieved. ?Not suffering from a tax haircut on the revenue stream enabled us to raise a significant amount of debt,? she says.

Well rated

Standard & Poor's has also given a good credit rating to the project. The senior secured notes have been assigned BBB-. This reflects a series of risks, including a high percentage of leverage to total capitalization at East Coast Power and the fact that the final maturity of the debt coincides with the final year of contract revenues from the Linden plant. The agency also stresses that the cash flows are primarily dependent upon three cogeneration projects with above market-priced electric contracts. There is also a high geographic concentration, as all the contracts are under the New York or New Jersey regulatory agencies.

These risks are mitigated by a number of strengths. Among them, the fact that the three projects all have investment grade ratings, with strong coverage ratios and historically high availabilities. In addition, the debt amortization schedule closely matches the cash flow available from the plants and mitigates refinancing risks.

?The three plants are strategically located,? says Hinds. According to Standard & Poor's the acquisition of these facilities fits well into Enron's strategy for the region, as the New York and the Pennsylvania-New Jersey-Maryland power pools are the largest in the eastern part of the US.

Says Dennis Magna, director at Bank of America in Charlotte: ?The real big value plant is Linden. It is one of the showcase plants that the bank market has financed in the past.? The Linden plant is also the most strategically located, as it has an underground transmission line into New York city and the plant is therefore classified as ?in-city? generation capacity. The strength of the Linden project lies in the power transmission constraints from west to east towards New York city. This may or may not be fixed in the future, as new transmission lines in certain cities need regulatory approval. The fact that Manhattan is an island makes this power constraint even worse. The only way additional transmission capacity can be created for New York city is by building new power facilities in the city.

The deal is a milestone. Says Lipshutz: ?Raising debt on the capital markets at very attractive rates was one of the major challenges. And the deal doesn't resemble other asset purchases that I am aware of.?

Says Hinds: ?Looking at the business opportunities, the strategic location, the partnership of Enron and Calpers, we felt comfortable to underwrite the transaction in a market that had a lot of turmoil. We were confident that we could get it to the Rule 144A market and indeed the transaction has gone very very well.?

According to Bank of America's Magna: ?In this environment, which is mostly merchant power-oriented we thought this deal would be well received.? The bank had to mitigate the risk that the loan would not be rated or it would not be able to go to the bank market. ?But we anticipated that the bond market would like it,? says Magna. ?We're kind of lucky, aren't we??

East Coast Power

Location: US

Total cost: $1.1 billion

Description: The project involves the acquisition of three power plants in New Jersey. All three power plants have long-term power-purchase agreements. The three plants are: Bayonne, which sells its power to Jersey City Power & Light; the Linden combined-cycle cogeneration plant, which will sell power to Consolidated Edison until 2017, and also to a refinery and a chemical complex; and the Camden plant, which will sell power to PSE&G for 20 years.

The special purpose vehicle, East Coast Power, was formed in December 1998 to acquire the interests in the three power plants formerly owned by Houston-based Cogen Technologies. The three plants have an aggregate capacity of 1,037MW. East Coast power will be indirectly owned by Jedi II, a partnership, which is owned by Enron and CalPers with a 50% stake each.

Financing:

1) Bridge loan: $726 million non-recourse tranche and a $130 million bridge with recourse to East Coast Power. The first tranche is priced at 125 basis points over Libor and the second tranche at 25bp.

2) Bond: $850 million bond. Bank of America is bookrunner, Lehman Brothers and Credit Suisse First Boston are lead managers. SG is co-manager.

Lawyers: Sharman & Sterling (lender) and Vinson & Elkins (borrower)